Stanhope Capital Fortnightly Bulletin

Period ending 15th September 2018

Tactical Positioning

We have not made any tactical moves in the last two weeks, preferring to see how the trade tariff posturing takes shape. Our sense is that there is an element of 'bark' being worse than 'bite' in the political rhetoric. For example, we have seen that President Trump's initial hostility over NAFTA (North American Free Trade Agreement) has ended up with the Mexicans striking a wide-ranging bilateral deal with the US in a relatively short period. Compromise may well rule the day between China and the US and it shouldn't go unnoticed that the Chinese Yuan has fallen by around 7% since April, providing an element of cushioning against higher tariffs. The scope for compromise provides support to our view, covered in the last bulletin, that we could move towards an environment which justifies an increase in the equity exposure in client portfolios.

Market Moves

	Equities *(Local Currency, incl. Dividends)*						
15-Sep-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	-0.5%	0.2%	-1.1%	-1.6%	-0.1%	-2.2%	-2.3%
Year to Date	4.4%	9.7%	-0.4%	-1.8%	-3.1%	-3.9%	-3.0%

	Commodities			**Currencies** *(vs. USD)*			**Gov't**
	BCOM	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[2]**
Last 2 Weeks	-1.4%	-0.7%	-1.2%	0.2%	0.8%	-0.9%	+14 bps
Year to Date	-5.3%	-8.4%	14.2%	-3.2%	-3.3%	0.6%	+59 bps

[1]Europe excluding UK

[2]US Treasury 10 Year Yield shows absolute, not percentage, change in yield

Source: Bloomberg

Markets failed to make much headway in the fortnight running up to the 10th anniversary of the Lehman Brothers collapse. Indeed, the NASDAQ Index shed 1.2% over the fortnight, though it is still comfortably the best performing major market index over the last ten years, up some 315%. By comparison, the S&P 500, which comes in second place, is up 202% since 15th September 2008.

The tech sector started September on the back foot largely on concerns of regulatory risk and its potential to hit earnings growth. A Congressional hearing on social media, with a particular focus on foreign influences on elections, appeared to unnerve investors. Facebook and Twitter, whose executives testified, were penalised with the share price of the two companies falling 7.6% and 14.4% respectively. Larry Page's absence on behalf of Alphabet/Google was punished to a lesser extent, with their shares down 4.4%, proving that sometimes being a no-show to a bad party is less painful than showing one's face.

Equity markets more broadly were lower, with the prospect of an escalating trade war with China continuing to be a disruptive influence on financial markets. The deadline for the end of the public comment period concerning a potential round of tariffs on $200bn of Chinese imports to the US passed with no announcement during the fortnight. Subsequently, tariffs of 10% on $200 bn of goods (rising to 25% at the end of the year) have been announced. In addition, President Trump is still threatening to impose tariffs on another $267 billion of Chinese goods if China responds by raising additional tariffs on US goods. Asian and emerging market equities struggled as a consequence, though they found some relief when US Treasury Secretary Mnuchin reached out to propose a new round of trade talks with China. Reports at the weekend suggested that China may be tiring of President Trump's negotiation tactics however and are considering skipping these talks. More tweets to follow.

Elsewhere, the central bank of Turkey, pressed by President Erdogan to keep interest rates down, raised its policy rate by 6.25%, much more than markets expected, to 24%. This was read as a strong signal from the authorities that they are determined to address the ongoing currency and confidence crisis before it turns into something costlier. The lira bounced on the back of the rate hike, up 7.1% over the fortnight versus the US dollar, though it is still down 38.5% year-to-date.

There was a small bounce for sterling following some of the latest Brexit newsflow. Comments from the EU's Chief Brexit Negotiator, Michel Barnier, have been getting incrementally more positive towards a deal being reached. He suggested that it was "realistic" and "possible" to get a Brexit deal done by the end of November. As for timing, a possible one-off summit on 13th of November now appears most likely for a deal. Between now and then there will be two EU summits; one next week and one in October. Appreciation of the pound was limited, however, by reports of a meeting in Westminster of fifty members of the European Research Group on the mechanics of ousting Theresa May.

Finally, yields on benchmark 10-year US government bonds rose 14 basis points and briefly broke above 3% for the first time in six months on the back of strong economic data, more on which below.

Economic Update

Recent data releases from the US provided further evidence that the economy is growing at a solid pace in the third quarter, albeit slower than the robust 4.2% increase recorded in the second quarter. In August, nonfarm payrolls increased by a sturdy 201,000, somewhat above the consensus forecast and well above the increase in the working-age population, generally estimated at 100,000 – 150,000 a month. At the current pace, the economy will generate more than two million jobs in 2018, marking the seventh consecutive year of job growth in excess of two million. This is a remarkable achievement for an economy now in its ninth year of expansion. The unemployment rate is 3.9%, marginally above the lowest level since the late 1960s, when civilians were being drawn out of the labour force to fight in the Vietnam War.

With the labour market running hot, companies are having to compete more aggressively for a dwindling supply of available workers. Average hourly earnings accelerated, up by 2.9% in August compared to twelve months ago. Upward pressure on wages will either need to be passed on to consumers in the form of higher prices or absorbed by companies willing to accept smaller profit margins. According to the latest survey of small businesses by the NFIB (National Federation of Independent Businesses), a record share of firms plans to increase worker compensation in the coming months while a smaller, but growing share, plan to increase prices.

While some market participants warn that rising inflationary pressures and the risk of an overheating economy justify a more aggressive monetary policy response, softer readings on consumer prices and retail sales for August dampened these fears. Notwithstanding, the recent job market data has cleared the path for two more Federal Reserve rate increases this year, with the first of these expected at the meeting later this month. This 25 basis point rise may well bring about the much-dreaded inversion of the yield curve, with the current spread between the 2 and 10 year Treasury yield sitting at a cyclical low of 21 basis points. Historically, an inversion of the yield curve corresponds with a recession one to two years down the road.

That said, we remain relatively sanguine for the moment and believe that the odds of an imminent recession remain low, barring a surprise from external shocks or a policy mistake. A robust job market, growing incomes, lower taxes and improved balance sheets mean that US households are exceptionally upbeat. The latest University of Michigan Consumer Sentiment Index highlighted this optimistic mind-set, increasing 4.6 points to 100.8. Furthermore, the NFIB survey of small business optimism jumped to the highest level since

1974 when records began. Capital spending plans were also reported as being the highest since 2007 and inventory investment intentions the highest since 2005.

On this side of the Atlantic, we got confirmation from the ECB that QE will be phased out in the final quarter of this year albeit still “subject to incoming data”. Rates guidance was also left unchanged. The main takeaway from the ECB’s President Draghi was the acknowledgment of risks coming from emerging markets, financial market volatility and the trade war. On Italy, he noted that thus far there have been little in the way of spillover effects from rising Italian government bond yields but advised that investors and savers should pay close attention to the drafting of the Italian budget and how it is debated in parliament.

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15 September 2018

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