Stanhope Capital Fortnightly Bulletin

Period ending 30th September 2018

Tactical Positioning

In recent days, we have implemented an increase in equity exposure for mandates that have been underweight their target exposure. As mentioned in our 31st August Bulletin, earnings and valuations seem reasonable and upward momentum is intact. Whilst 'trade tantrums' keep surfacing, compromise (as we have seen over NAFTA) may rule the day, improving investor sentiment into year end. We are also on the point of cutting our bond exposure, removing duration exposure over 2 years. US interest rates may stabilise in 2019 but the risk of owning bonds with medium and longer term maturity dates far exceeds the reward. Indeed, volatility in bond markets is comparable to volatility in equity markets, making their safe-haven status something of a misnomer.

Market Moves

	Equities (Local Currency, incl. Dividends)						
30-Sep-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	1.0%	0.3%	1.0%	2.8%	5.7%	1.0%	0.9%
September	0.5%	0.5%	-0.1%	1.2%	5.5%	-1.2%	-1.4%
Year to Date	5.5%	10.1%	0.6%	1.0%	2.4%	-2.9%	-2.1%

	Commodities			Currencies (vs. USD)			Gov't
	BCOM[2]	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[3]**
Last 2 Weeks	3.4%	-0.1%	6.2%	-0.2%	-0.3%	-1.4%	+7 bps
September	1.9%	-0.7%	4.9%	0.0%	0.5%	-2.3%	+20 bps
Year to Date	-2.0%	-8.5%	21.2%	-3.3%	-3.6%	-0.9%	+66 bps

[1]*Europe excluding UK*

[2]*Bloomberg Commodity Index*

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

Source: Bloomberg

Global markets advanced 1% over the fortnight as investors took the escalation of the US-China trade war in their stride. On 18th September President Trump announced that $200 billion worth of Chinese goods would be immediately subject to a 10% tariff, rising to 25% at year end. China's reaction was measured; they retaliated with 5-10% tariffs on $60 billion of US imports and announced that they would defend the renminbi against further devaluation. The above measures seem to have been more restrained than markets were anticipating, and risk assets rallied.

Some positive trade news came through on the last day of September when the US, Mexico and Canada announced that a deal has been struck between the three countries replacing the 'NAFTA' trade deal with the 'USMCA' (US-Mexico-Canada Agreement). The deal is expected to be signed into law in November and while not the catchiest of names, it seems to address several grievances of the US whilst not being overly punitive on either Mexico or Canada. The deal contains restrictions against "unfair" trade practices particularly in the auto-industry; advantageous agricultural provisions to give US dairy farmers greater access to Canada; and some interesting intellectual property provisions in the pharmaceutical industry. The Mexican peso and Canadian dollar were beneficiaries of the announcement. It is not clear whether the deal increases or decreases the chances of the US and China coming to a similarly pragmatic resolution to their trade dispute.

Japan was the best performing market over the two weeks (+5.7%) following the re-election of Prime Minister Shinzo Abe as leader of the Liberal Democratic Party, a relatively dovish Bank of Japan statement and a weaker yen. Donald Trump and Shinzo Abe met last Sunday to discuss trade and agreed to a bilateral “Trade Agreement on Goods” rather than the multilateral Trans Pacific Partnership Trump withdrew the US from early in his presidency. Japanese commodity and manufacturing businesses were the biggest winners as they have benefited from easing trade fears and a strong US economy, while Japanese auto stocks suffered badly ahead of the US-Japan trade summit and have yet to recover.

European equities performed positively over the fortnight despite increased volatility in the Italian equity and debt markets. On Friday the Italian cabinet announced that they had agreed to a 2.4% headline budget deficit in 2019, which was well above prescribed EU limits. The Italian 10-year government bond yield rose as high as 3.26% and the Italian equity market fell 3.7%. The worst affected sector was Italian banks which fell sharply by 7.9%, the most since June 2016, on concerns that the populist government is now on a collision course with the European Union and rating agencies may downgrade Italian debt. The budget will need to be submitted to the European Commission by 15th October and could lead to a confrontation should they deem the budget non-compliant. If no agreement is reached, the Commission could begin corrective procedures, potentially leading to sanctions by year end. This is an extreme scenario but the risk of it occurring in the coming months could lead to further volatility in Europe.

US Government bond yields continued their trajectory upwards as the Federal Reserve (Fed) raised the base rate another 25bps on Wednesday, in line with market expectations. At just 2% to 2.25% the Fed Funds rate now exceeds the Fed’s preferred measure of inflation (see Economic Updates) meaning that for the first time since the global financial crisis 10 years ago the US has a positive real interest rate. The rate rise was expected by the market and people were more interested in hearing the Fed’s forward guidance following the announcement. As the Fed dot plot (of interest rate forecasts) remained unchanged (indicating one more rate hike this year and three in 2019) and Chairman Powell’s statement confirmed rate rises would remain gradual, the meeting was viewed as positive for markets. Given the strong economic growth in the US and high earnings growth we don’t see the tightening as damaging for US equities at this stage, however it will be important to watch inflation closely in case the Fed is forced to increase the pace of rate hikes.

There was a mixed picture in Emerging Markets as China bounced off multi-year lows when the State promised to stimulate domestic demand through policy action, whilst India suffered following news of the default of nonbank financial lender IL&FS, leading to a sell-off in financials. India has also been affected by a resurgent oil price and fiscal tightening to control the country’s widening trade deficit. The rupee which has fallen almost 10% this year was put under further pressure when the US raised rates earlier this week and it will be interesting to see if the Indian Central Bank looks to stabilise the decline at its next meeting in early October. Elsewhere, Turkey released a new economic plan lowering the country’s growth targets and Argentina negotiated a much-needed expansion of the IMF bailout to $57 billion which should ease any liquidity concerns in the short run. Asia and Emerging Markets have been the worst performing equity markets in 2018 and now look cheap on both a relative and absolute basis at c.12x next year’s earnings. While there are undoubtably risks in various countries it is difficult to ignore the attractive demographics, productivity growth, and low cost of production many of these markets have relative to developed markets. This, combined with the recent sell off, could offer a good entry point.

The oil price rose 6.2% over the last two weeks as OPEC indicated it was content with an $80 oil price when it announced no plans to increase production. People are beginning to talk about a return to $100 per barrel oil as Iranian production is curtailed by US sanctions and Venezuela’s production drops off amid the country’s economic crisis. Given US inventories are now at a three year low it debatable whether Saudi Arabia and Russia can fill the void in production.

It feels like we should start releasing a “Brexit Bulletin” given the vast amount of coverage it is inevitably getting in the British press. In short, after having hit a 10-week high sterling fell 1.5% against the US dollar after EU leaders rebuffed Theresa May’s “Chequers” plan in Salzburg. The EU leaders took a tough stance on Mrs May’s proposal effectively rejecting the deal outright and giving her four weeks to save the exit talks. The Conservative party conference started on Sunday and will be carefully watched owing to internal party tensions. October and November are likely to be volatile for sterling given various negotiation deadlines.

Economic Updates

As mentioned previously, the US Core PCE (Personal Consumption Expenditure) Price Index came in slightly softer than expected at +2.1% year-on-year with the headline figure at +2.3%. Other data releases from the US illustrate a continuing trend of strong US economic growth and a tight labour market. Q2 GDP growth was confirmed at +4.2% quarter-on-quarter, while regional business surveys from New York and Philadelphia Federal Reserve Banks printed firmly in expansionary territory and US jobless claims fell to a fresh 48-year low. US consumer sentiment rose to a six-month high and is near the highest level since 2004, the latest sign of growing confidence in the US economy. US PMI readings were weak on services (52.9 vs. 55.0 expected) but strong on manufacturing (55.6 vs. 55.0 expected). It is difficult to reconcile the disappointing services number with employment at such highs, but some commentators are attributing the relative weakness to Hurricane Florence and other storms that hit the US in September.

In Europe, regional PMI numbers came in weaker than expected with Germany having a slight miss on the manufacturing PMI number, which fell from 55.9 to 53.7. While the regional slowdown was sharper than expected, growth remained robust and the overall euro area composite PMI posted 54.2 as the bloc’s dominant services industry beat forecasts. Spain, France, Italy and Portugal released inflation numbers on Friday and, on aggregate, the euro area CPI missed expectations with the core reading falling to +0.9% year-on-year vs. expectations of +1.1%, indicating some softness in inflation. Germany, however, posted a bumper CPI print as the annual rate returned to +2.2% year on year, taking it back to its May highs.

In Japan, August CPI beat expectations at +1.3% year-on-year sparking a small sell off in Japanese government bonds. Japan also surprised to the upside when the August retail sales grew 2.7% compared to the same period a year earlier. There was a similar story in the UK where retail sales unexpectedly increased last month (+0.3%) as the warmest summer on record encouraged shoppers to splash out.

Finally, in China the official manufacturing PMI for September fell to 50.8 (vs 51.2 expected) perhaps indicating that talks of a trade war are beginning to have knock-on effects in the manufacturing sector. In the non-manufacturing sector things were more positive, the reading came in above expectations (54.9 vs. 54.0 expected).

JONATHAN BELL
IVO COULSON
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2nd October 2018

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