Stanhope Capital

Stanhope Capital Fortnightly Bulletin

Period ending 15th December

Tactical Positioning

Markets remain unsettled ahead of the US Federal Reserve meeting this week and any further news on the China-US trade situation. Investors are currently extremely sensitive to economic and political dialogue, and softer economic data only adds to negative sentiment. Whilst bearish sentiment is currently at a high, as measured by the AAII Bear Index, this could change quickly if better news were to emerge on any number of fronts. As a result, we favour keeping our current neutral exposure to equities. For UK clients, we continue to look for opportunities to add to sterling.

Market Moves

	Equities *(Local Currency, incl. Dividends)*						
15-Dec-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	-4.3%	-5.7%	-2.8%	-1.9%	-4.2%	-1.6%	-1.5%
Year to Date	-4.7%	-1.5%	-8.3%	-7.2%	-9.8%	-9.2%	-9.8%
	Commodities			**Currencies** *(vs. USD)*			**Gov't**
	BCOM	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[2]**
Last 2 Weeks	-1.5%	1.3%	0.5%	-0.1%	-1.3%	0.1%	-10 bps
Year to Date	-6.1%	-5.0%	-15.3%	-5.8%	-6.9%	-0.6%	+48 bps

[1] *Europe excluding UK*

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

Source: Bloomberg

There's a lot of red in the numbers – sadly this is not what is meant by a "Santa rally". It's been a difficult couple of weeks for equity markets with major bourses falling across the board. The only positives for the period, gold and oil, bring little solace to investors in the context of recent declines. Gold is benefitting from a fall in monetary tightening expectations in the US and oil has seen small respite from falls as recent OPEC cuts work against US sanction wavers and supply growth; neither exactly harbingers of festive cheer.

Yields on the US Treasury 10 Year bond have continued to fall into December, with the difference between two and 10-year Treasury yields narrowing to just 0.09% intraday on 11th December (currently at 0.16%), the lowest level since summer 2007. Whilst consensus holds that a move into negative territory is a classic overture to recession, there is no set timing as to whether or when such a recession would commence. The immediate risk at this stage, however, is the impact on investor sentiment which could itself fuel a contraction; stock price falls (which have begun) lead to a loss of confidence, delaying investment, inhibiting growth, and ultimately leading to looser interest rate policy. However, history would remind us that bull markets can continue when yield curves are flat (i.e. bond yields are similar across the maturity spectrum). The US is facing another fiscal cliff this month which, along with seasonal tax management, has also led to investors paring back their exposure to US risk assets.

The European Central Bank (ECB), not put off by concerns about an economic slowdown, formally ended its asset purchase programme on 13th December, €2.6trn later. The ECB will continue to reinvest proceeds from existing bonds into other Government debt issues as they are repaid: think turning off the taps, as opposed to emptying the bath, and also indicated that they are working on a replacement for TLTRO-II ("targeted longer-term refinancing operation two" which allows European banks to borrow money at lower interest rates than the ECB usually offers). The benchmark deposit rate was left unchanged and negative at -0.4%, with the lack of ECB discussion about future rate rises leading many to rethink their expectation of the next one coming in late 2019. "Continuing confidence with increasing caution" is apparently ECB's President Draghi's new mantra.

Economic Update

Equity markets have also been upset by softer economic data. Chinese retail sales growth came in below expectations, albeit at an enviable level of 8.1% year-on-year, prompting the Governor of the Chinese Central Bank to promise a continuation of supportive monetary policy. Amidst growth fears, and continuing trade tensions with the US, China continues to manage the economy pragmatically. Just recently, they have begun rethinking their “blue skies” ambition for cleaner air, which could have proved stifling for economic growth, and are relaxing their industrial capacity management policies. In efforts to appease the US they are: revising their “Made in China 2025” high-tech manufacturing master plan, preparing to rewrite an industrial policy to accommodate greater access for foreign companies and are said to have purchased 1.5 to 2m tons of soybeans from the US. Notably, the 90-day trade truce between the US and China comes to an end on 1st March 2019 – a “hard deadline” according to the US, after which time they intend to raise tariffs on $200bn Chinese goods from 10% to 25% if no deal is struck.

In Japan, the sharpest decline in business spending since 2009 has caused Q3 GDP to shrink 2.5% quarter on quarter, the largest contraction since Q2 2014 and significantly below expectations.

Stocks in Europe are weighed down by political issues, with Brexit at the top of the naughty list followed by civil unrest in France. There has been little progress regarding the Brexit-limbo in which the UK finds itself. A confidence vote in the Conservative Party has seemingly assured Prime Minister May’s position as leader of the Party for another year, but we are no closer to establishing where we will finish on the “hard Brexit to no Brexit” scale. Positive economic data for the UK, such as a low and stable unemployment rate and the fastest pace of wage growth for 10 years, along with low equity market valuations, has begun to attract interest from contrarian equity investors, but whilst Brexit holds sterling in its grasp, it’s hard for anyone to take the plunge with confidence.

Looking ahead to 2019, most financial institutions’ forecasts are out. US earnings growth predictions have fallen to around 8%, with Morgan Stanley even predicting a mid-year earnings recession, i.e. two successive quarters of declining profits. Growth and inflation forecasts are being downgraded in Europe, reflecting weaker global growth as well as patchy domestic conditions. Macro Strategy Partnership feel that the ECB’s long-term productivity growth expectation for the Eurozone of 1.5% annually is unrealistic and overly optimistic, noting that the average has been only 0.03% since the formation of the euro in 1999. In a more optimistic mode, Oxford Economics note that several factors support growth in 2019. Namely, the upwards-trending US investment cycle and the likelihood that the growth deceleration in China will be gradual. They feel that “fundamentals are in place for strong European investment growth once political uncertainty clears”. Less political uncertainty? Roll on 2019!

JONATHAN BELL
IVO COULSON
SOPHIE OUTHWAITE
15 December 2018

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