Stanhope Capital Fortnightly Bulletin

Period ending 15 January 2019

Tactical Positioning

As we discuss below, investor sentiment has greatly improved in the short term validating the case for ‘staying put’ during the wild gyrations of December. Nevertheless, all eyes are on the US company results season which kicked off this week. So far, there have been no upsets and we are keeping our equity exposure close to neutral. However, amongst the other ‘diversifiers’ that we have in portfolios, we are weeding out a few areas that could look less attractive if conditions deteriorate. This includes exposure to leveraged loans which can be quite illiquid and convertibles which are correlated to equity markets. As far as possible, our aim is to make the investments that are outside the equity ‘bucket’ a stabiliser with limited equity market correlation, providing an offset in the event that risk assets have another bout of nerves.

Market Moves

	Equities *(Local Currency, incl. Dividends)*						
15-Jan-19	World	US	Europe[1]	UK	Japan	GEM	Asia
Last 2 Weeks	3.9%	4.2%	3.3%	2.5%	3.6%	3.4%	3.2%

	Commodities			Currencies *(vs. USD)*			Gov't
	BCOM[2]	Gold	WTI Oil	EUR	GBP	JPY	UST 10Y[3]
Last 2 Weeks	4.5%	0.5%	14.8%	-0.5%	0.8%	0.8%	+3 bps

[1] Europe excluding UK. [2] Bloomberg Commodity Index. [3] US Treasury 10 Year Yield shows absolute, not percentage, change in yield
Source. Bloomberg

The first two weeks of 2019 were a lot kinder to risk assets (particularly equities, high yield corporate bonds and commodities) than the closing weeks of 2018, during which many arguably reached oversold levels. Investors are feeling sanguine given strong signs that the US Federal Reserve (“the Fed”) may be on the point of pausing its cycle of interest rate rises and trade talks between the US and China are progressing well. Also, valuations of many risk assets finished 2018 at reasonable levels, leaving room for a rally. Meanwhile, markets are taking the ongoing US government shutdown in their stride.

Positive factors have been the centre of markets’ attention and helped them regain a modicum of composure with the VIX index, a measure of the S&P 500’s implied volatility, falling back below 20, having reached 36 on December 26th (close to the year-high seen in February 2018).

US monetary policy turned from being a headwind to risk assets to a tailwind as Fed Chair, Jerome Powell, acknowledged concern regarding the direction of Fed policy in the face of rising macroeconomic risks. He said the Fed “will be patient as [they] watch to see how the economy develops” and already are “prepared to adjust policy quickly and flexibly”. The setback seen in December appeared to have been enough to persuade the Fed to pause their interest rate hiking cycle and has resulted in a softening of the US dollar. In Europe, the minutes of the latest European Central Bank meeting demonstrated its board was also worried about growing economic risks.

Meanwhile, as far as one can tell, trade talks between the US and China have been more about press statements, memos and tweets rather than achieving anything concrete thus far, although President Trump has publicly predicted a trade deal will be agreed. It’s worth noting that due to the ongoing US government shutdown, the Trade Representative’s office is operating with less than 30% of its full-time staff. We are now on day 25 and 800,000 government employees are without pay. Negotiations between President Trump’s Administration and the Democrats (who control the House of Representatives) reached a new low when the President stormed out

of a meeting with House Speaker Pelosi and Senate Minority Leader Schumer calling it "a total waste of time" and expressing his outrage in a tweet. The sticking point is Trump's insistence on circa $5 billion of federal funding for a southern border wall which is an anathema to the Democrats. Trump has threatened to declare a national emergency to bypass Congress. Credit ratings agency, Fitch, warned that the US may lose its AAA rating (the highest possible) if the government shutdown continues until March and the debt ceiling issue is not resolved.

In the UK, politics has once again been dominated by Brexit. Most MPs are against a no-deal Brexit, however, no-deal is currently the default position on the 29th March departure date, although this date can be pushed back by an extension of the Article 50 period. On the last day of the fortnight, the House of Commons voted to reject Theresa May's withdrawal agreement with the EU by 432 votes (including 118 Conservative MPs) to 202. Markets have taken this as a positive sign as no Brexit or a permanent customs union now seems more likely than a no-deal Brexit.

In bond markets, the yield on 10 year US Treasuries was little changed over the fortnight. Despite the rally in risk assets (normally accompanied by higher bond yields as 'safe haven' assets sell off concurrently), bond yields were held down by signs of a pause in the Fed's cycle of interest rate rises, and lower growth and inflation expectations. High yield corporate bond spreads (the extra yield they offer over government bonds) contracted 0.75% in the US and 0.20% in Europe on improved investor sentiment. Oil recovered all of its -11.3% leg down in the previous fortnight. On the supply side, Saudi Arabia has cut output, while on the demand side, the Fed pausing its hiking cycle is positive for economic growth.

Economic Updates

Economic data in the US was mixed (NB, some data releases were postponed due to the ongoing government shutdown). The employment report generally came in well above expectations: non-farm payrolls were +312k (vs. +178k expected) and average hourly earnings were up +0.4% month-on-month (vs. +0.3% expected). NFIB small business optimism and consumer credit growth also beat consensus expectations. However, the manufacturing PMI (53.8 vs. 53.9 expected), the ISM manufacturing (54.1 vs. 57.7 expected) and non-manufacturing PMIs (57.6 vs. 59.6 expected) and the unemployment rate (3.9% vs. 3.7% expected) disappointed. The consumer price index was in line with the market's expectations at 1.9% year-on-year.

In Europe, macroeconomic data was similarly mixed. The services PMIs for the Eurozone (51.2 vs. 51.4 expected), Eurozone CPI (1.6% year-on-year vs. 1.8% expected), and factory orders (-1.0% month-on-month vs. -0.2% expected) were below market consensus, whilst Eurozone retail sales (+0.6% month-on-month vs. +0.2% expected), investor confidence (-1.5 vs. -2.0 expected), unemployment (7.9% vs. 8.1% expected) and the Eurozone trade balance (€19 billion vs. €13.7 billion expected) beat expectations. The manufacturing PMIs for the Eurozone (51.4), Germany (51.5) and France (49.7) were in line with market expectations.

In the UK, monthly GDP growth (+0.2% month-on-month vs. +0.1% expected), the services (51.2 vs. 50.7 expected) and manufacturing (54.2 vs. 52.6 expected) PMIs, beat expectations but the trade balance (-£12.0 billion vs. -£11.4 billion expected), industrial production (-0.4% month-on-month vs. +0.3% expected), consumer credit (£0.9 billion vs. £1.0 billion expected) and money supply (+0.0% vs. +0.6% expected) were disappointing.

The impact of the US-China trade restrictions as well as a slowdown in global growth became clearer as China's trade data for December 2018 came in much weaker than expected. Exports fell -4.4% (vs. +3.0% expected) year-on-year and imports were down -7.6% (+5.0% was expected) over the same period. The Caixin manufacturing PMI came in a shade below 50 (indicating a contraction) at 49.7 (vs. 50.3 expected), which also rattled investors at the start of January (before market sentiment turned owing to the factors outlined above). Chinese CPI also came in below market consensus at 1.9% year-on-year (vs. 2.1% expected). China is using its policy tools to stimulate its economy, for example it cut banks' reserve requirement ratio, freeing up an estimated $116 billion for new lending (according to Reuters).

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15 January 2019

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