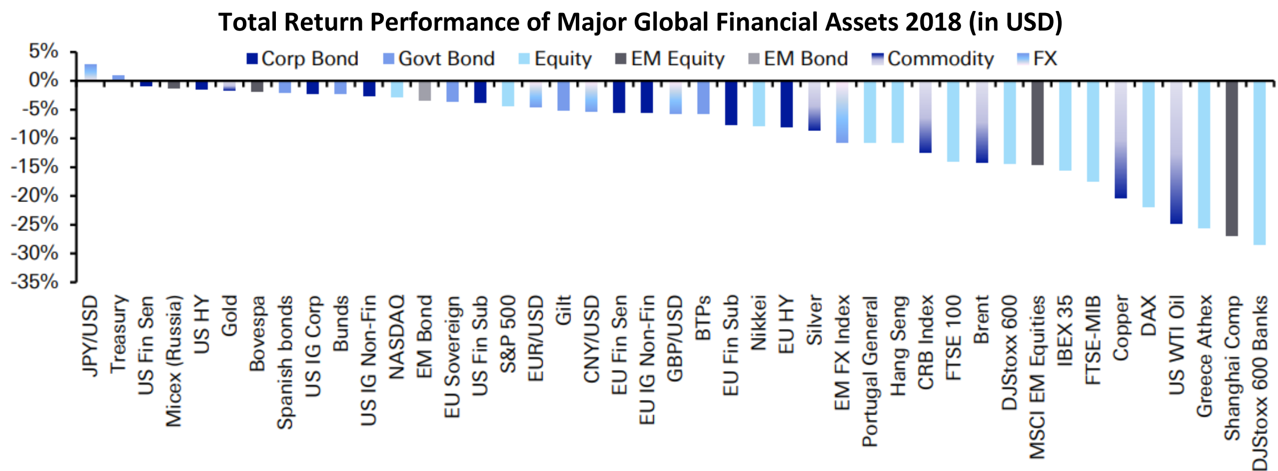
Stanhope Capital Fortnightly Bulletin

Period ending 31 December 2018

Tactical Positioning

As we discuss below, markets in the closing weeks of the year have been virtually impossible to call with any certainty. Commentators point out that no major asset class advanced meaningfully in 2018. The last time this occurred was 1974. Against this background, we have not made any notable tactical moves since mid-December preferring to stay with our neutral to slightly underweight exposure to equities and a reduced budget in bonds, whilst favouring cash and selected hedge funds as an alternative. Short term, the markets need to see some closure on issues such as the U.S budget and China/US trade relations. Looking at the bigger picture, global growth in 2019 may well be slower but markets seem to have rushed to discount a possible recession. As the master Keynesian, Paul Samuelson, observed the stock market has predicted 9 of the last 5 recessions. In our view, slower growth is a prospect, but recessionary forecasts are premature. Short term issues aside, risk assets seem to offer the potential for recovery from a relatively oversold state.



Source: Deutsche Bank, Bloomberg Finance LP, Mark-It

Market Moves

	Equities (Local Currency, incl. Dividends)						
31-Dec-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	-3.1%	-3.5%	-3.3%	-1.6%	-5.9%	-1.0%	-0.9%
December	-7.3%	-9.1%	-6.0%	-3.5%	-9.8%	-2.5%	-2.3%
Year to Date	-7.7%	-4.9%	-11.3%	-8.7%	-15.1%	-10.1%	-10.6%

	Commodities			Currencies (vs. USD)			Gov't
	BCOM[2]	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[3]**
Last 2 Weeks	-5.5%	3.6%	-11.3%	1.4%	1.4%	3.4%	-21 bps
December	-6.9%	4.9%	-10.8%	1.3%	0.0%	3.5%	-30 bps
Year to Date	-11.2%	-1.6%	-24.8%	-4.5%	-5.6%	2.8%	+28 bps

[1] *Europe excluding UK*

[2] *Bloomberg Commodity Index*

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

Source: Bloomberg

In the last two weeks of the year, equity markets initially fell sharply before regaining a degree of composure in the period after Christmas. Investor sentiment was generally hurt by rising interest rates in the US, reports that President Trump is exploring avenues to dismiss the Federal Reserve (Fed) Chair, Jerome Powell, a partial US government shutdown and continued China/US trade tensions. There were a number of unusually large daily moves, most notably on Boxing Day when the S&P 500 Index, the Dow Jones Industrial Average and the Nasdaq experienced their greatest rise in a single session since March 2009. According to a Reuters report, this was the result of a $64 billion rotation out of bonds into equities by defined benefit pension funds. The VIX Index, a measure of the markets' implied volatility, jumped from 21.6 at the start of the fortnight to 36.0 and then fell back to 25.4 at year-end.

In terms of US monetary policy, it appeared to be the language of the Fed's policy statement rather than the 25 basis point interest rate rise which caught the market off-guard. Although the Fed's message implied that fewer rate rises than previously forecast may be required this year, its language was not as dovish as the market had hoped. Investors were unnerved by a growing realisation that the Fed will only reverse its planned policy path and support equity markets if the sell-off affects the real economy. That said, US money markets now imply only a 9% chance of an interest rate rise in 2019 and consequently the US dollar has softened against most major currencies. The focus hereafter will be on whether the Fed has tightened policy too much. Given his blunt critique of the Fed's interest rate path and flirtation with sacking Jerome Powell, it is unlikely that President Trump will recast himself as a defender of the Central Bank.

The antipathy between Trump and the Democratic Party reached new heights with a partial US government shutdown after the Senate failed to break an impasse over Trump's demand for $5 billion to build a wall on the border with Mexico. In the absence of a deal, funding for around a quarter of US federal agencies lapsed and hundreds of thousands of federal employees were furloughed or required to work unpaid. Whilst this is the third occasion an agreement on federal funding has failed in 2018, it is by some distance the longest deadlock and credit rating agencies estimate that the US economy stands to forego growth of around $1.2 billion each week the standoff continues.

Elsewhere, China/US trade tensions rumbled on, exemplified most strikingly by the indictment of two Chinese nationals accused of hacking 45 US technology companies and government agencies, and in a separate case, the hacking of Hewlett Packard and IBM. With regards to Hewlett Packard and IBM, evidence points to hackers acting on behalf of China's Ministry of State Security, using access to each company's networks as a launch pad to infiltrate systems belonging to their clients, including US government agencies and the armed forces. At the end of the month, however, equity markets were comforted by Trump's tweet that he had a positive call with Chinese Premier Xi Jinping and that a possible trade deal was progressing well. In contrast, Secretary of the Treasury, Steven Mnuchin's decision to phone the CEOs of the six largest banks in the US, about their liquidity resources, spooked rather than reassured markets.

In bond markets, the yield on 10 year US Treasuries fell 21 basis points over the fortnight. This resulted in the spread between 2 and 10 year Treasuries narrowing to a new cyclical low of 9.5 basis points just before Christmas. As mentioned in previous bulletins, inversion of the yield curve (longer-term debt has a lower yield than shorter-term debt) has sometimes been a historic predictor of recessions. In commodity markets, the price of oil (WTI) dramatically fell 11.3% to $45.41 per barrel, largely owing to Saudi Arabia's budget plan which includes an ambitious oil revenue target of $177 billion for 2019. This indicates that Saudi Arabia is either assuming oil prices of $80 per barrel or planning to pump far in excess of the 10.2 million barrels per day announced earlier in December. The current price of oil gives little credibility to the first option. Gold was more resilient, up 3.6% over the fortnight.

Economic Updates

Economic data in the US was generally weak. The Empire State Manufacturing Survey came in at 10.9 vs. 20.0 expected and in the fine print, there were declines for new orders. This subdued picture was reinforced by the Richmond Fed Manufacturing Index which fell 22 points month-on-month, as shipments and new orders weakened, and came in at negative 8 vs. positive 15 expected (levels greater than zero signal growth). Despite this being the largest fall on record, it came from a surprisingly elevated level. Concerns also mounted in the real estate

sector, as the NAHB Housing Market Index came in at 56 vs. 60 expected, marking the lowest reading in three years and remarkably the biggest combined two-month decline since October 2001. Not all was gloomy, according to Mastercard, as US retail sales during the holiday season rose 5.5% to over $850 billion, the strongest in six years.

On this side of the Atlantic, grey clouds also threatened to depress sentiment further. Firstly, the Eurozone Macro Surprise Index fell to negative 75, which with the exception of the Global Financial Crisis, shows the lowest recording since 2003 when records began. Secondly, the ifo Business Climate Index matched Germany's recent disappointing Purchasing Manufacturers Index (PMI) readings coming in at 101.0 vs. 101.7 expected. On the other hand, the European Commission finally endorsed Italy's revised budget plan, (hopefully) preventing another immediate flare up of tensions and reducing the likelihood of the bloc launching an 'Excessive Deficit Procedure'. The price Italy paid included agreeing to lower its deficit target to 2.04% vs. the original proposal of 2.4% and choosing to make these savings from a less ambitious social spending policy and a smaller reduction in the retirement age. In the UK, Brexit uncertainty appeared to weigh on business optimism, as the GfK Consumer Confidence Index came in at negative 14, the lowest reading since July 2013, but in line with expectations.

In China, economic data was mixed. The Non-Manufacturing (services) PMI rose to 53.8, up from a 15-month low of 53.4 in November, indicating that stimulus measures may be starting to feed into the domestic economy. Moreover, the Peoples Bank of China announced that it intends to grant a targeted medium-term lending facility (TMLF) for financial institutions based on the growth of their loans to small and private businesses. Nevertheless, the Manufacturing PMI dropped to 49.4, the first time in two years it has settled below the expansionary mark of 50. Elsewhere, Chinese auto sales fell 14% year-on-year, adding to fears that the global auto industry has entered its first recession since the Global Financial Crisis.

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IVO COULSON
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31 December 2018

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