Stanhope Capital

Stanhope Capital Fortnightly Bulletin

Period ending 15th February 2019

Tactical Positioning

Despite solid markets over the last two weeks the US corporate earnings outlook, mentioned below, is a cause for some concern. At the end of 2018, earnings forecasts for 2019 stood at 10%, this has now been downgraded to just 5% with a risk of falling further. Upgrades and downgrades in earnings often determine the direction of stock markets but, in this case, the hope of a rebound in growth later in the year has mitigated any negative effect. If these hopes start to fade, we may need to adjust our models' 'risk budget'. Near term, a satisfactory resolution to the China-US trade situation could have a positive bearing on earnings as well as sentiment. With this in mind, we are not in a rush to cut equity market exposure quite yet, but pragmatism may be required.

Market Moves

	Equities (Local Currency, incl. Dividends)						
15-Feb-19	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	2.2%	2.7%	2.8%	4.1%	0.4%	-0.8%	0.4%
Year to Date	9.6%	10.9%	9.3%	7.9%	5.7%	6.4%	7.0%

	Commodities			Currencies (vs. USD)			Gov't
	BCOM[2]	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[3]**
Last 2 Weeks	0.4%	0.0%	3.3%	-1.3%	-1.7%	-1.5%	+3 bps
Year to Date	5.9%	3.0%	22.4%	-1.5%	1.1%	-0.8%	-2 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 general 'risk-on' mood has continued in February as markets look past poor retail sales in the US and slowing GDP growth in Europe to focus on the importance of positive trade talks between the US and China, an end to the threat of a second US government shutdown and dovish policy from central banks.

The deadline of 1st March to come to an agreement on various trade issues between the world's two largest economies is fast approaching and global markets seem to be taking an optimistic view on the potential for a positive resolution. This was supported by President Trump hinting that he would be open to extending the deadline should it look like they are getting close to agreeing a deal. However, not all the news was positive as National Economic Council Director, Larry Kudrow, announced that no decision to extend has yet been made. Kudrow cited "the sizable distance" between the two countries on the most difficult issues such as intellectual property protection, forced technology transfer and cyber theft. Should both countries fail to reach an agreement, the Trump administration will hike tariffs on $200bn of Chinese-made goods from 10% to 25%. Whether a deal is reached or not, China and the US maybe on a collision course on a number of key issues and the risk of tariff escalation and continued flare-ups may continue to test financial markets through 2019.

Another key concern for investors was averted late in the fortnight as Trump and Congress came to an agreement on funding for much of the US government, thus avoiding another shutdown. The previous 35-day shutdown, the longest in US history, ended only two weeks ago and looks to have had a significant effect on 4th quarter economic growth. Whilst the saga has evolved – 16 US States are now suing Mr Trump for commandeering military funds to help build his wall – the S&P 500 rallied on the back of the news and ended the period up 2.7%, now less than 6% off its September highs. Friday's close marked the 8th consecutive week the US market has posted a gain and the S&P passed through its 200-day moving average, an important technical support level for some market participants.

With the trade dispute, government shutdown and various central banks reversing course, fundamentals have taken a back seat in the news recently. The US is now 70% of the way through its Q4 earnings season and according to FactSet, c.70% of companies have surprised to the upside (62% on revenue growth). The earnings growth rate for S&P 500 companies has averaged 13% so far whilst Europe is on target for a growth rate closer to 3%. On a slightly more concerning note, FactSet are now predicting US companies' earnings will fall, on aggregate, in the first quarter of 2019 due to the fall in oil prices, poor consumer sentiment and the boost to earnings from the tax cuts 12 months ago falling out of the earnings growth figures.

In Asia, markets got off to a slow start as the Chinese New Year led to low trading volumes. However, investors returned from a week long Lunar New Year in a buying mood and the Shanghai Composite Index added 2.5% and the CSI 300 Index rose 2.8%, marking the biggest weekly gain in three months for both indices. Asia, as a region, traded virtually flat as other markets performed less well. The Indian market posted its worst decline in four months as a terror attack in the disputed Kashmir territory added to the country's uncertain political outlook. Following the event, Modi threatened that the perpetrators would have to pay "a very high price", adding a potential conflict with Pakistan to the list of investors' concerns.

European stock indices were up 2.8% in the fortnight despite a German GDP figure which indicated no growth for the second quarter in a row. The insipid growth has led to a weaker euro and German bund yields have fallen from 0.5% in October to 0.09% today; a two-year low. The decision by the European Central Bank (ECB) to halt the €2.6 trillion bond buying program may turn out to be premature, however, the ECB is unlikely to reverse the decision in the near term, although rate rises are off the radar until 2020 at the earliest.

Meanwhile in the UK, the FTSE 100 was the best performing developed market in the fortnight, helped by gains on Wall Street, hopes of a US-China trade deal and sterling falling. The political picture has not improved however as the UK parliament rejected Prime Minister May's strategy of withdrawal from the EU. While the vote was not legally binding, it is a reminder that May's Brexit strategy, which requires further concessions from Brussels, does not have support even from her own party. It appears increasingly unlikely that law makers will be able to agree on a withdrawal agreement by the deadline date at the end of March.

Oil rallied 5% last week with West Texas Intermediate crude pushing above $55 per barrel. The commodity is now up 22.4% year to date supported by more positive news on trade tensions and the announcement that OPEC and Russia have voluntarily cut supply. This combined with US sanctions on Venezuela is pressuring global oil supply.

Economic Updates

On the surface, Donald Trump's State of the Union boast about the "unprecedented economic boom" seemed premature given some of the economic numbers coming out of the US during the fortnight. The delayed retail sales number for December disappointed as retail sales fell 1.2%, marking the largest monthly fall since 2009. Retail sales, ex-autos, were down almost 2%. This appears to have two contributing factors: a fall in consumer confidence, driven by the government shutdown and market turmoil in Q4, and poor weather conditions across the country. The number was particularly poor across the Midwest which was most affected by the polar vortex so it could be that these numbers are transitory. With unemployment low and wages rising, there is no reason at this stage to expect a structural decline in consumer confidence.

Industrial output in the US was also poor in January as total output of the nation's factories, mines and utilities slipped 0.6%. But perhaps the most concerning number was the headline decline in manufacturing output which fell 0.9%, reversing the (disappointing) increase of 0.8% in December. Major contributors to the fall were an abrupt decline in auto production and a 1.5% reduction in business equipment output which could indicate a decline in global growth if it points to softer capital spending going forward. We note that this setback follows seven consecutive months of solid gains.

Inflation data came in at 1.6% in January, a 19-month low that was pulled down by declining energy prices over the month. The less volatile core CPI, which removes energy and food, remained at +2.2%, and in line with the FED's long-term target. Whilst this may indicate an economy with less momentum going into 2019, January marked the 10th consecutive month in which there were more job openings than unemployed workers. As the labour market tightens further, we are likely to see wage inflation push CPI higher.

As mentioned above, German GDP growth was poor in the fourth quarter coming in flat at +0.02%, marginally avoiding a recession having fallen in the previous quarter. To a large extent, this weakening trend is linked to the slowdown in Chinese growth which is a key export market for German goods, particularly autos. Needless to say, any further breakdown in the talks with the US and China would likely exacerbate the situation. German retail sales also fell dramatically in the 4th quarter, posting the steepest decline in shopping in the country in 11 years. This dragged down the rest of the eurozone as the 19 countries' sales fell 1.6% month-on-month in December. According to Sentix, the eurozone is dangerously close to stagnation but "neither politicians nor central banks seem to have really grasped the extent of the loss of momentum."

China released its January trade stats at the end of the fortnight and exports unexpectedly rose 9.1% year-on-year vs. an expected fall of 3.3%. Imports declined 1.5% vs. an expected fall of 10.2% and China's trade with the US dropped by 2.4% in USD. Imports from the US meanwhile slumped by more than 41% leading to China's January trade surplus with the US at $27.3bn. This is some way below the peak in November of $35.5bn, although November numbers were impacted by front loading before tariffs came in and the January number is significantly higher than the average of the last four years. Friday's Chinese credit growth surprised to the upside and augured well for the months ahead as it has been a lead indicator of Chinese growth.

Finally, Japan grew its GDP by 1.4% (annualised) in the fourth quarter as it recovered from several natural disasters earlier in the year. Strength was driven by consumer and business spending despite pressure on exports from the slowing Chinese economy and the US-China trade dispute. Expectations are for further growth in the current quarter, although a slowdown in global growth and the introduction of a planned sales tax in October could dent consumer and investor confidence.

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19th February 2019

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