

Market Overview

More than the weather is heating up. The EU’s threat to Swiss independence makes China’s stand-off with Hong Kong look benign, while Iran’s militarized response to US pressure and the ever-escalating rhetoric between the US and China are occasionally moving even UK political dramas off the front page. Bull markets – and the US bull market is now at an all-time high – love a bit of worry.

Although US bond yields seem to be bottoming, illustrated in Figure 1 below, downward pressure remains intense globally as the ECB says it is open to further QE and more bonds enter negative yield territory. Even some junk bonds are trading with negative yield in Europe. Is this sustainable, or is the US leading the turn in this powerful thirty year trend?

Meanwhile, US unemployment is as low as in the late ‘60s, productivity is rising and unit labour costs are still falling. What more could you ask of ‘sound money’? The trouble is that this kind of soundness has the stability of a spinning top and is based on unprecedented central bank intervention. Investors are haunted by two questions as equity markets soar. The first is ‘When will it end?’, and the second is ‘Given exceedingly low bond yields, where else but equities do you go?’ There is some near-term comfort because the US is in a mini cycle upswing, even if there really is a long-term interest rate trend change coming down the tracks. In any case, the December sell-off made the Fed lose its nerve and it is now in ease mode.

China’s credit cycle is likely to loosen in sync with the US, not least because as the Fed eases, capital tends

Figure 1: A History of US Rates: What Goes Down Must Come Up?

US generic government 10-year yield, 1962-present



Source: Bloomberg

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to flow into China. Chinese state support is increasing along with a resurgent construction sector and strong business confidence, which offsets trade weakness and massive tariff increases. China's financial system is looking stressed at the edges. A small bank, Baoshang, collapsed in June and a mutual fund house defaulted on some products, so the Peoples' Bank of China pumped 600bn Yuan (\$125bn) into the system via brokerages and was forced to extend the deposit guarantee to all banks as interbank rates spiked. Big crises start with small ones, but there can be plenty of false warnings. President Xi Jinping is likely to keep running with a fiscal deficit larger than forecasted, given his credit and trade war issues. He is also loosening bond market restrictions.

Eurozone equities are expected to trough soon as the ECB is forced to resume easing and Mme Lagarde may restart QE during the year. Germany's benchmark Bund yields are plumbing new depths at minus 0.75%. This is impressive given the stresses of Brexit, a zombie banking sector (is it now cheap?) and rebellions in the UK, Italy and Visegrad regions.

Europe AsiaPac and Emerging Markets are, to a large extent, hostage to the main protagonists: the US and China and the US Dollar.

The simultaneous bull markets in equities and bonds raise the issue of whether bonds are the best diversifier at this stage. If rates rise hard then bonds could suffer, but we use shorter durations to limit downside. There is a case for using gold for diversifying equity risk in inflationary periods, but gold has needed no help from inflation to act as a speculative release valve, along with Bitcoin, over the last month.

The yield on 3-month US government bonds is now lower than on 10-year notes—the infamous inverted yield curve. Such inversions have preceded every US recession for the last 50 years, on average by about 9 months, so we will be considering asset allocation carefully. However, there are many other factors at play, including signs of a positive mini cycle upswing in the US as we head into the final year before the next US Presidential election, traditionally never short of market-friendly stimulus.

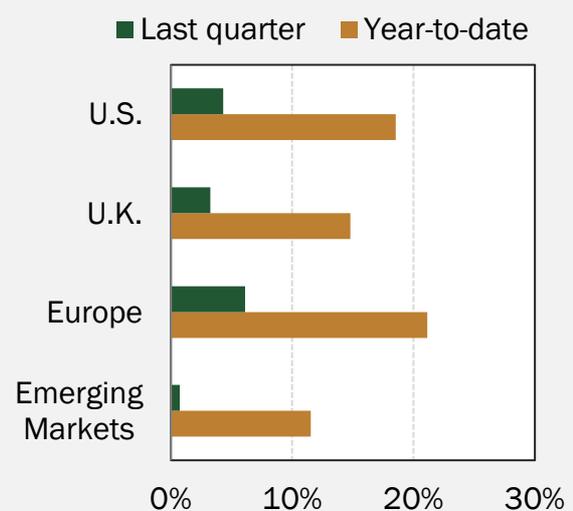
Asset Classes

Equities

Since the end of March, it's been a roller coaster ride for global stocks. As one Bloomberg analyst—an apparent Sinatra fan—pointed out, the lyrics to That's Life managed to perfectly capture the experience of equity investors in the second quarter, with the MSCI ACWI “riding high in April” (+3.4%), “shot down in May” (–5.8%), and finally managing to “change that tune...back on top in June” (+6.6%). Despite these ups and downs, through the end of June, equity markets had significantly extended a first quarter rally back from their late-2018 retracement, with US stocks up 4.3%, UK stocks gaining 3.3%, European equities advancing 6.1%, and EM stocks adding a modest 0.7% (see Figure 2).

Figure 2: Equity Market Performance

Returns as of 30 June 2019

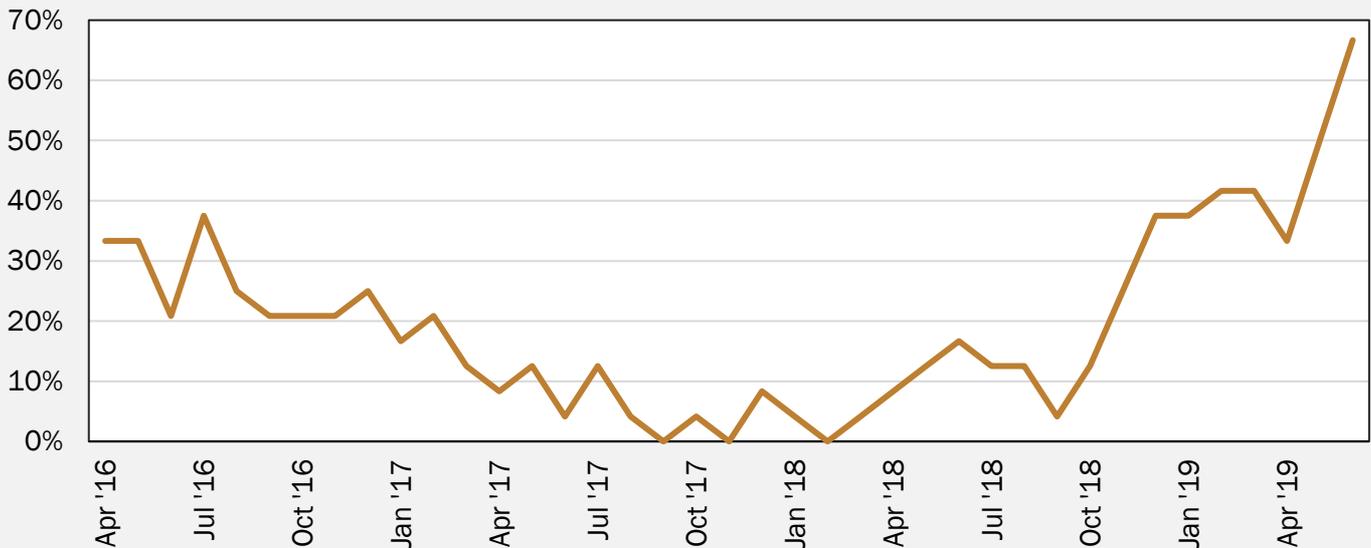


Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg

Figure 3: Rapidly Broadening Signs of a Weaker Global Economy

Beginning in the second half of 2018, an increasing number of countries reported weaker manufacturing data. As of 30 June 2019, some of the world's largest economies, including China, Japan, Germany, and the UK, were among the two-thirds of developed and emerging markets tracked by Markit that had slipped into contraction territory, with PMI below 50.

Percentage of countries tracked by Markit with a PMI below 50



Source: Manufacturing PMI from Markit via Bloomberg

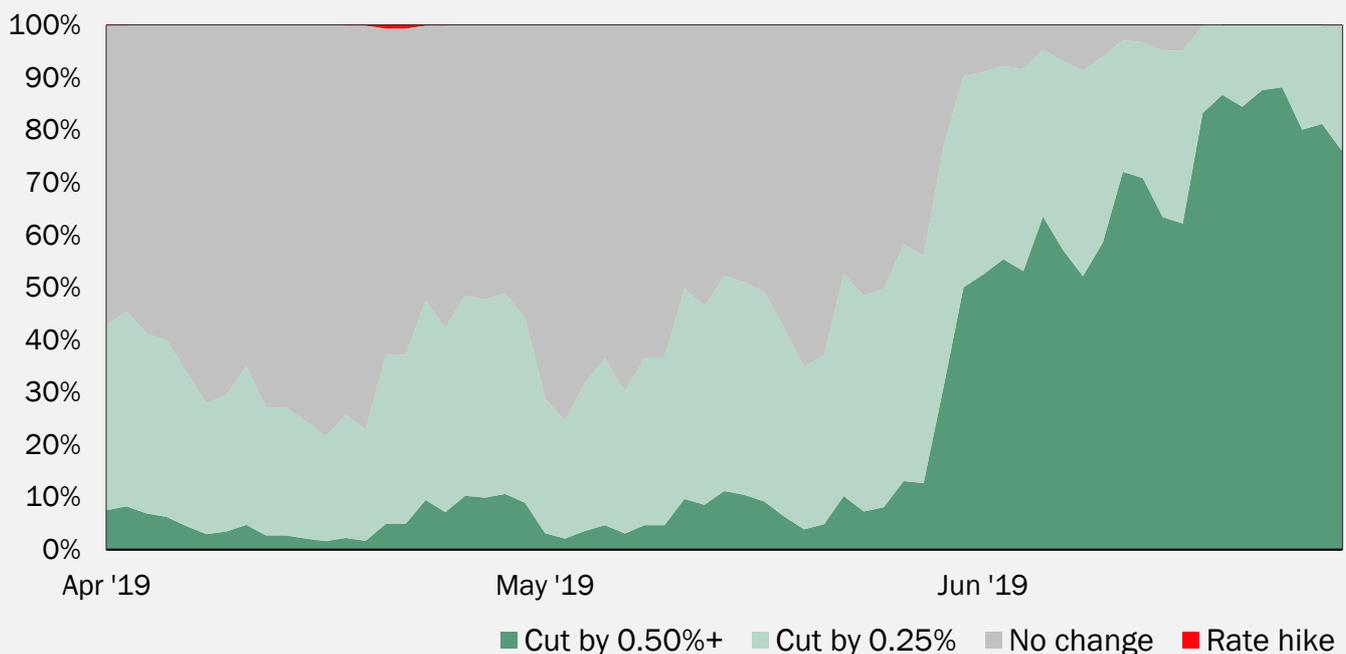
Trade tensions likely explain part of the bumpy ride for stocks in Q2. While April negotiations in Beijing and Washington hinted at possible de-escalation, rhetoric ramped up at the beginning of May, with the US lashing out at China and other trade partners—including a short-lived threat of tariffs against Mexico—which contributed to a temporary dip in equities. Near the end of June, apparently productive talks at the G20 summit between Messrs Trump and Xi again gave investors some hope on the trade front, culminating in a surprising reversal on June 29th of the US ban on sales to Chinese smartphone vendor, Huawei. Notwithstanding the potential thaw in relations between the world's two largest economies, the trade war has clearly already taken a toll, with China's manufacturing activity slipping back into contraction territory during the second quarter, placing the nation in good company with the other 15 of 24 countries tracked showing a PMI below 50 as of the end of June, including Japan, Germany, and the UK (see Figure 3 above).

Indeed, mounting concerns of a global economic slowdown prompted the world's central banks to double down on the first quarter trend toward monetary easing, arguably the most significant driver of stock market gains in the second quarter. In the US, Fed rate hikes to close out 2018 gave way to a "patient" pause in monetary interventions during Q1, which turned to consensus expectations for rate cuts by mid-May, spurred on by comments from Fed officials seemingly paving the way for meaningful reductions in target rates by the end of 2019. At the end of June, futures traders on the CME pegged a falling Fed Funds rate by September 2019 as a sure thing, and the odds of a cut of at least half a percent by at better than three-in-four (see Figure 4 on next page).

Figure 4: Placing Bets on a Fed Rate Cut

After nine rate hikes since 2015, the last coming in December 2018, increasing fears of a weakening economy led the Federal Reserve to soften its tone. At the beginning of April 2019, Fed Funds futures implied over a 50% chance that rates would remain unchanged through September 2019; by the end of the quarter, traders were betting on cuts of at least a half percent.

Probability of various Fed Funds target rate scenarios as of 30 Sep. 2019 implied by futures prices

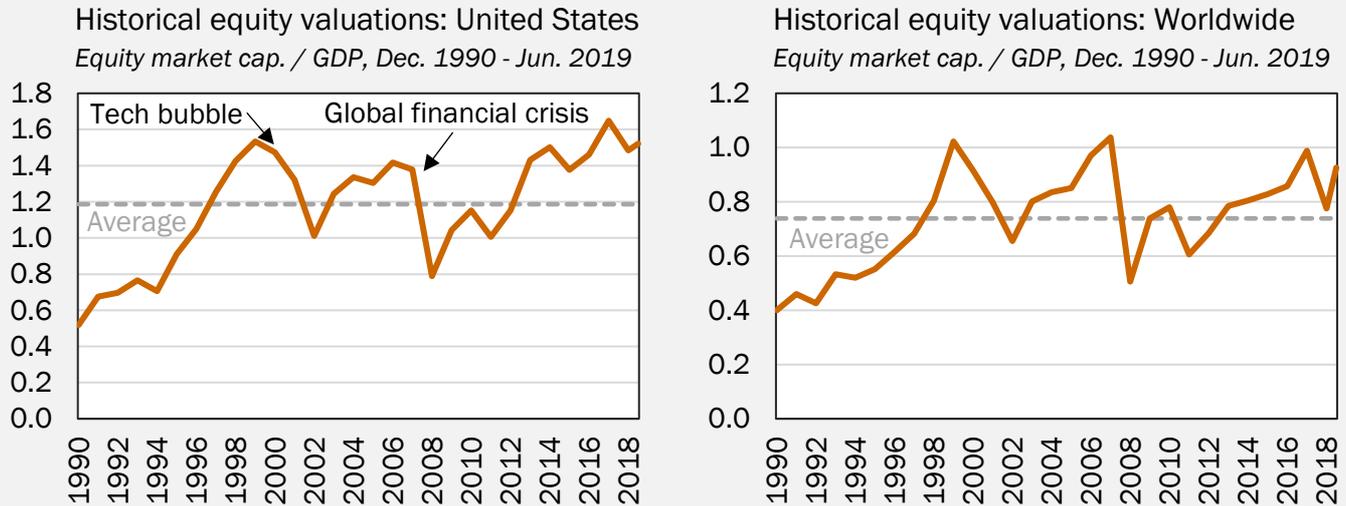


Source: FedWatch via CME

The end result of expectations for further easing has been a surge in equity valuations to record highs, with the popular “Buffett indicator”—the ratio of total market capitalization to GDP—reaching levels not seen in the US since the Tech Crash and surpassing those witnessed just prior to the Global Financial Crisis (see Figure 5 on next page). Global markets seem less expensive, but certainly aren’t cheap by historical standards. Given the threat of an impending economic downturn, geopolitical risks galore, not to mention public concerns about financial drivers of social inequality creating the potential for a rollback of deregulation and tax cuts that have helped sustain a decade-long stock market rally, investors would be wise to temper expectations for equities going forward. Incidentally, while Emerging Markets (EM) stocks have climbed by over 11% this year, they still represent a potential haven for equity investors, with the MSCI EM showing a forward P/E of 12.1 vs. 15.6 for Developed Markets (DM) stocks in the MSCI World Index as of the end of June.

Figure 5: After a Decade-Long Rally, Global Equities Ain't Exactly Cheap

The well-known Buffett Indicator—simply the ratio of a region's market capitalization to its GDP—suggests stock prices are high relative to fundamentals, at least on a historical basis, both in the US and abroad.



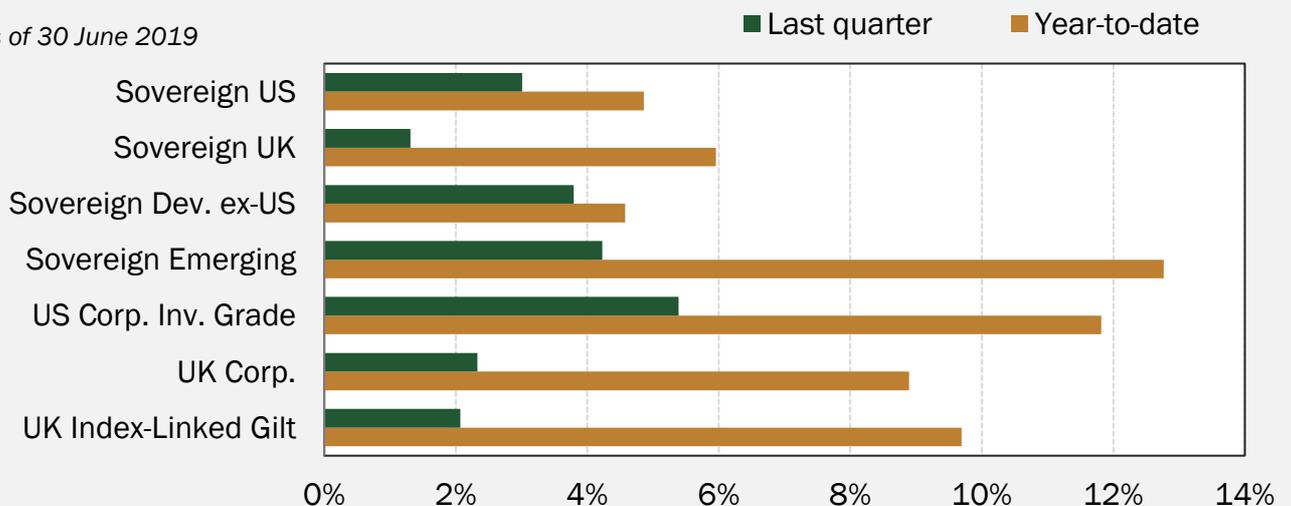
Source: IMF, World Bank, Bloomberg; GDP for June 2019 based on full-year 2019 estimate from IMF.

Fixed Income

Largely as a result of the macroeconomic headwinds and policy response just discussed, global yields continued to sink lower in the second quarter, producing solid returns for bond investors (see Figure 6). At the end of June, yield curves shifted further from optimistic expectations set last year, with the US yield curve firmly inverted, and UK gilts, on the heels of deteriorating economic data and heightened risks of a “hard” Brexit, flirting with levels not seen since that fateful 2016 referendum (see Figure 7).

Figure 6: Fixed Income Market Performance

Returns as of 30 June 2019



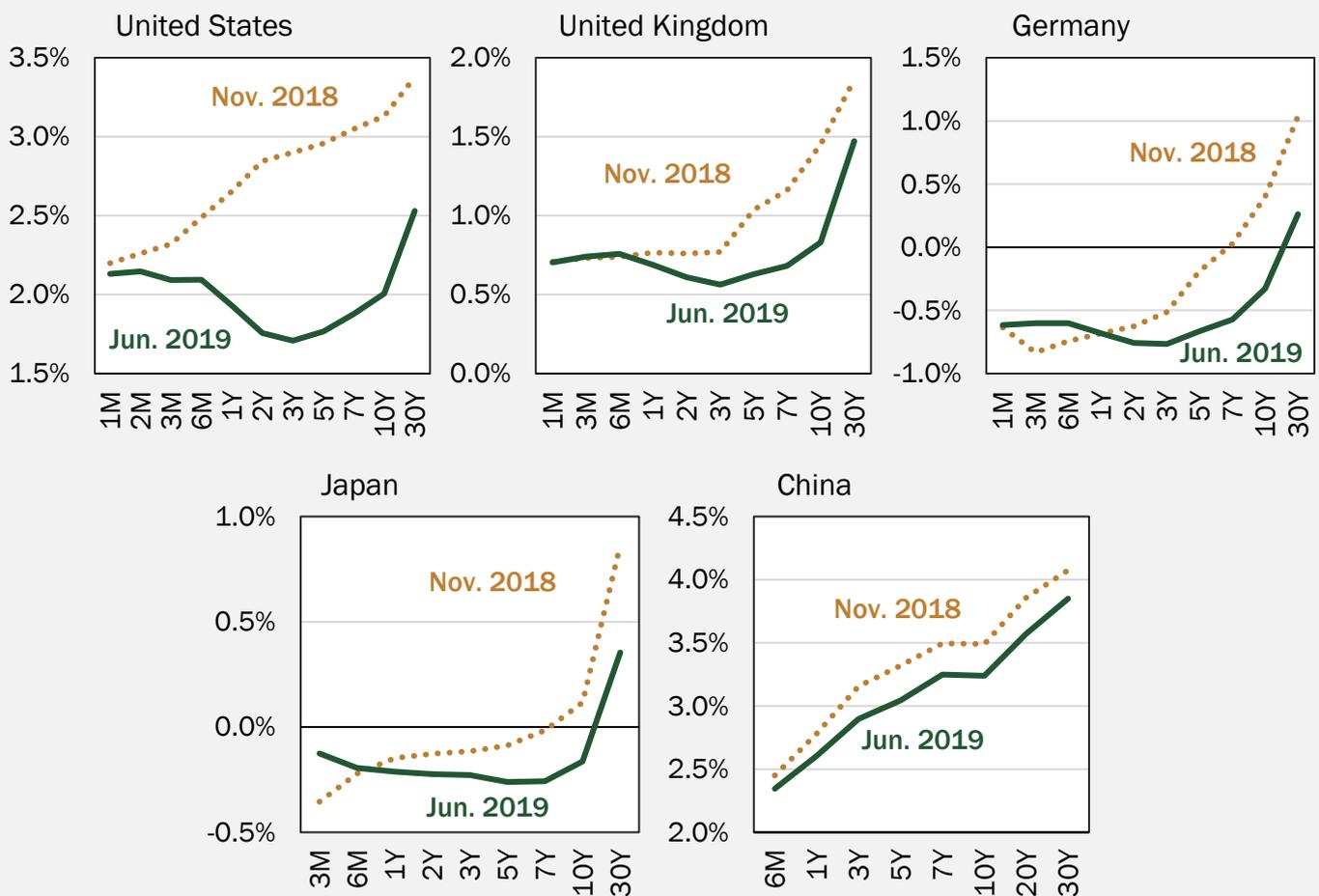
Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP.

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To get a sense for just how far rates have fallen in recent months, we note that by the end of June, investment grade government and corporate bonds making up the Bloomberg Barclays Global Aggregate Bond Index included more than US \$13 trillion worth of issues with negative yield, making up almost 25% of the index. Despite rock-bottom rates, demand for global bonds remains strong. So strong, in fact, that as the quarter ended, Austria was reportedly contemplating floating yet another 100-year issue. Their last foray into “century bonds,” maturing in 2117, currently yields just over 1%.

Figure 7: Sovereign Bonds Pricing a Downturn, Not Offering Much Yield

Central banks have gone from tightening mode in November 2018 to a decidedly dovish posture through the end of June 2019, with inverted curves and negative yields signaling fears of a slowdown and challenging investors to look elsewhere for income.



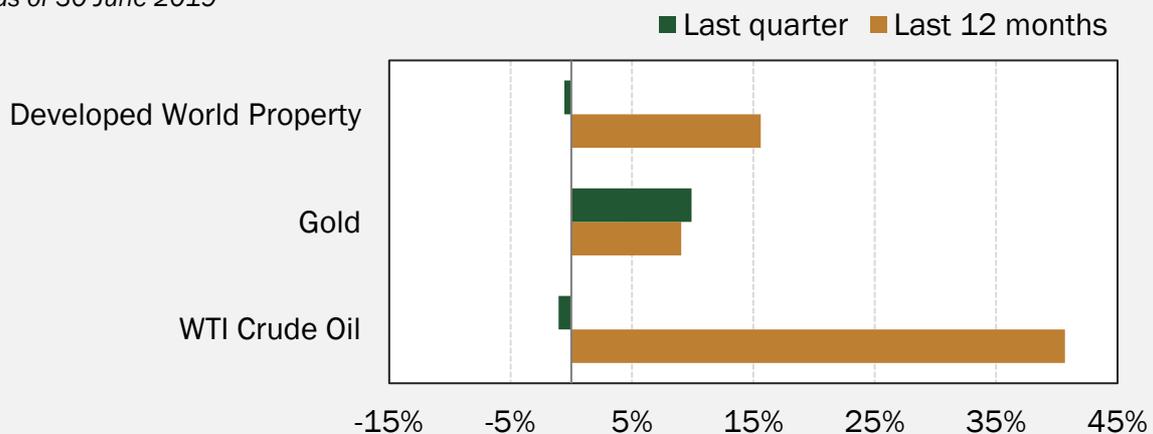
Source: Bloomberg

Alternatives

REITs retreated ever so slightly in the second quarter, as developed world property fell -0.6% through the end of June, bringing year-to-date returns to 15.6% . An increasingly dovish monetary policy has led investors reaching for yield to pile into this income-oriented segment, driving richer valuations for many REITs in 2019, although the resulting “NAV premium,” along with fairly strong fundamentals, has the effect of providing firms in the sector with currency to fund growth through acquisition.

Figure 8: Alternatives Performance

Returns as of 30 June 2019



Source: iShares Int'l Dev. Real Estate ETF (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg

In commodities markets, gold benefited during the second quarter from increasing expectations for 2019 rate cuts—which would reduce the opportunity cost of holding bullion—and persistent geopolitical fears, ending the quarter up 9.91% . Notwithstanding political and economic instability in Venezuela and an escalating conflict between the US and Iran, oil prices retreated modestly, returning -1.0% in Q2 on fears that a slowing global economy would put the brakes on demand for crude (see Figure 8).

Looking Ahead

The tensions between the US and China are not merely about trade, but stem from deep strategic rivalry and are likely to remain a part of the landscape, causing at least intermittent pressure on markets, for some while. This quarter should give more clarity on the efficacy of China's domestic strategies and the impact of trade tariffs.

What else does the quarter hold? In the UK, everybody expects Mrs May to tell Her Majesty on July 22nd that her successor in the Conservative party will be able to form a Commons majority – but this is not a foregone conclusion. In the Eurozone, zombie banks and renewed QE are candidates for investment headline material.

The second quarter saw the S&P 500 Index touch new highs despite the above and this quarter has kicked off with a rally into new territory, supported by most other equity markets round the world. Bonds have risen as longer-term US interest rates stopped climbing and settled back to 2016 levels, though in doing so they have created a yield curve inversion. This is normally a reliable leading slowdown indicator and we can expect investor attention to be focused on US growth trends this quarter. Of critical importance is results season. One of the reasons for such strong US markets compared to the rest of the world has been the growth in corporate profit as a share of GDP, and we will shortly see how this is holding up, and how companies see their outlooks going into 2020. Valuations in the US are higher than elsewhere, with forward PERs around 17x in the US and 13x outside it, Emerging Markets on 12x, so the valuation baton could pass from the US to others. It should be born in mind that the flip side of corporate profits being such a high proportion of GDP is that less is going into workers' pockets. This, coupled with a decade of QE pumping up asset prices for the wealthy, makes the question of Mrs May's successor of particular interest to UK investors.

Closing Comments

Our Investment Team continuously monitors and works to evolve and adapt our strategies which are designed to dynamically take advantage of market volatility and asset divergences. Now more than ever, our knowledge in a systematic disciplined approach to investing is essential in managing the investments that you have entrusted to us to help meet your financial needs. Please contact us with any questions or if you would like to meet in person to discuss our approach. We greatly appreciate your business and confidence in us.

Key Economic Releases and Events for Q3 2019

UNITED KINGDOM

Bank of England Official Bank Rate

Release: 1st August & 19th September

Brexit: The UK is expected to leave the EU on 31st October 2019

EUROZONE

ECB Monetary Policy Meeting:

25th July & 12th September

UNITED STATES

FOMC Rate Decision:

31st July & 18th September

FOMC meeting minutes:

10th July & 21st August

CHINA

GDP YoY%: 14th July

Caixin China PMI Composite:

4th August & 3rd September

BoP Current Account Balance:

9th August

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