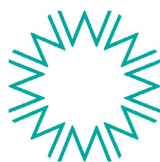
MARKET PERSPECTIVES

APRIL 2018

THE LAST QUARTER...

- World stock markets fall, led by the FTSE 100, which experiences its worst quarter since 2011 – down 8.2% (-7.2% adding back dividends).
- Volatility returns to levels last seen in 2015.
- Wall Street experiences its biggest daily fall for six years.
- Sterling appreciates by 3.7% against the US dollar, which is weak against all the major currencies.
- Japan's economy has its longest run of unbroken growth since the 1980s.
- UK manufacturing sees its longest period of expansion since at least 1968; unemployment is the lowest for 43 years.
- RBS reports its first profit for ten years.
- The Wellcome Trust issues a century bond yielding 2.5%.

> "Tariffs! They are the politics of the future, and of the near future. Study them closely and make yourself masters of them."
>
> Joseph Chamberlain, 1902



WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Bond yields are at last moving up.

At long last bond yields have moved up materially, as we have been predicting them to do for some time. In the US, the long bond yield touched 3.2% – a much more realistic level given strong economic growth, higher short term interest rates and rising inflation. For a long time bond yields around the world have been far too low – so low, in fact, that just two years ago well over half of the world's government bonds were offering negative yields (many still are): such was the demand for a supposedly safe haven for cash, investors were willing to pay governments to borrow their money. The impact of ultra-low interest rates has been discussed many times in *Market Perspectives:* on a positive note, it has enabled asset prices to recover from the 2008-09 crash, given good companies and credit-worthy individuals a once-in-a-lifetime opportunity to secure extraordinarily beneficial long term finance and has helped economic growth. On the other hand, near-zero interest rates have been unhelpful to bank profitability and consequently the availability of bank credit, they have penalised risk-averse savers and have propelled asset prices to potentially alarming valuations; they have also enabled poor quality credits (e.g. 'junk' companies and dodgy governments) to raise money too easily, thus sowing the seeds of the next round of defaults.

We continue to believe that bonds will produce very low returns.

Aside from the obvious challenge which low bond yields present to fund managers who are trying to make money for clients, the question of the degree to which the movement in bond yields is correlated with equity prices has arguably been a more important consideration. Running an underweight position in bonds given their ultra-low yields and our confidence in the economic recovery has been both a relatively easy call and in line with the consensus of most active fund managers (in contrast to passive investors and highly regulated banks, pension funds and insurance companies, all of which are required to hold long bonds whatever the yield). Prior to the Great Financial Crisis, bond prices on the whole were positively correlated with equity prices: in other words, falling bond yields were good for stock markets because they indicated that inflation was under control and that valuations could be underpinned. However, during 2008-09 this relationship reversed and collapsing interest rates coincided with crashing equity prices, presaging an economic depression. Ever since then, falling bond yields have tended to be greeted with dismay by equity investors. This negative correlation between bond prices and stock markets reached a crescendo in early 2016 when the world suffered a serious deflation scare. As a consequence we were compelled to reduce our return expectations on all the investment mandates we offer, with the largest cuts being applied to the most bond-heavy mandates.

Change in correlation with equities presents managers with a problem...

Nonetheless, throughout this period we have continued to advocate some exposure to fixed interest in portfolios because a negative correlation with equities offers valuable diversification in an uncertain world. However, as yields normalise it seems likely that the diversification benefit of fixed interest exposure may disappear – or at least not be present reliably enough to justify increasing our low bond weightings on occasions when we want to protect portfolios from falls in equity markets. At some stage the differential in valuation of bond and equity markets will correct so that the balance between them is restored. There seemed to be an element of this in the US during February: as the equity market fell by nearly 10% in short order, bond yields quickly jumped to 3%, but then backed off this peak as investors apparently felt that the bond / equity risk / reward dynamic looked more nuanced again. Unfortunately, in most other parts of the developed world bond yields still look far too low to tempt active investors to increase weightings materially – especially if the correlations are becoming unhelpful again. We continue to look for alternatives to include in portfolios but neither gold, nor infrastructure and property funds nor hedge funds can really do what long dated bonds should do for a diversified portfolio. We can go some way towards insuring portfolios against 'tail risk' through the Waverton Protection Strategy, which has now been running for two years – but this is a conundrum which does not have a straightforward solution. In the meantime, we remain underweight bonds; that said, long dated US treasuries are beginning to look more tempting again – but the alarming rate of debt issuance in the US, and the falling value of the US dollar are notable caveats which explain why US treasuries look so much cheaper than the other major government bond markets.

...because bonds are no longer the diversifier that they were.

Correlation of FTSE All Conventional Gilts Total Return and FTSE All Share Total Return calculated on a rolling 60-day basis

Source: Bloomberg, Waverton

OUTLOOK FOR EQUITY MARKETS

It was the great nineteenth century historian and Whig politician, Macauley, who wrote, "Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular." Conversely, protectionism can be a vote winner in the short term. The Smoot-Hawley Tariff Act of 1930 was in response to the 1929 crash and now President Trump is imposing tariffs on China in order to support his popular base in the 'rust belt' states. Given that Smoot-Hawley is generally accepted to have exacerbated the Great Depression, stock markets are right to be worried about a trade war.

Free trade can be painful for electorates.

The first lot of tariffs, announced on March 1st, were shrugged off by the stock market. They were restricted to aluminium and steel, and very closely targeted towards 'dumping' by China, thus playing to a tune which appeals to many other countries besides the US. The second batch of tariffs, on the other hand, did spook the equity markets because they affected a wide range of Chinese exports, totalling $60bn. Bearing in mind that Mr. Trump has in his sights a US-Chinese trade deficit of $375bn, there is a concern that this is just the start of something very material – especially as the US Trade Representative, Robert Lighthizer, is a strong advocate of taking on China. There is an article expanding upon this subject published on the Waverton Insights web page, the conclusion being that, for all the bluster, it is unlikely that there will be a full-blown trade war between the US and China. China's initial response to the latest US measures was muted, threatening just $3bn of tariffs on imports of frozen pork, wine and certain fruits and nuts. However, in early April China escalated its response by threatening tariffs on $50bn of imports from the US. But this is likely still a negotiating tactic: for example, it is very difficult to see how China can substitute from other places its need for US soya beans.

The US and China are each playing to their domestic audiences...

There is a more fundamental issue at stake, of which the current trade spat is but one symptom: is US hegemony in the global economic system gradually being ceded to China? It may be that the Chinese allow Trump some leeway on his vote-winning rhetoric in the interest of wider geopolitical gains. Early in his presidency, Trump withdrew the US from the TPP (Trans-Pacific Partnership) trade agreement amid great fanfare, which was undoubtedly to China's advantage long term. More recently, China has stolen a march on the US by hosting Kim Jong-Un in Beijing in advance of the US President meeting the North Korean leader; also, on March 26th an oil futures contract was launched in Shanghai based on a basket of medium and heavy (i.e. largely middle eastern) crude oils to be traded in Rmb rather than the lighter European (Brent) or American (West Texas Intermediate) oil traded in US dollars.

...but this overlays geopolitical rivalry.

Whatever the ultimate outcome of this particular US / China dispute, trade policy around the world is going to have a big impact on equity markets over the coming years. Whilst we hopefully won't see outright 1930s-style protectionism and a full blown bear market, the political and economic climate looks like it will nevertheless be dominated by trade related issues for some time to come. Brexit is largely a debate about trade policy and it has divided the UK today just as the Conservative party was split asunder by the corn lawns in the 1840s and tariff reform was a contentious issue nationwide in the early 1900s. Protectionism is not solely about tariffs on manufactured goods: regulation is the protectionists' instrument of choice so far as services are concerned. In the financial services sector, the arguments are well rehearsed; but they are only just getting going in the technology sector, which until now has more or less had 'free rein' to harvest private data, exercise global domination etc. without much scrutiny from governments. This is changing as the EU flexes its muscles against Facebook and Alphabet (i.e. Google), and Trump publicly attacks Amazon. Meanwhile, as the West agonises over the rights and wrongs of Amazon's, Google's and Facebook's market power and use of data, the Chinese state is hugely accelerating its investment in Artificial Intelligence (AI) and Russia is investing in cyberwarfare; both of those superpowers will pursue their national interests, often through the medium of state owned enterprises, without any of the squeamishness of liberal democracies. China is already using AI to monitor the activity of its citizens on a grand scale.

Free trade has never been a 'given'; the technology sector also faces restrictions.

All of these issues have had a significant bearing on equity markets over the last quarter. The prospective price earnings multiple on world equities has fallen from 16 ½ to 15 times (i.e. only slightly above the average since 2001) as investors have demanded a higher risk premium from equities in the light of these threats: an all-out trade war would certainly threaten an economic slump, so it is understandable that the rhetoric of tariffs should result in a derating of equities even if the reality turns out to be more benign. Separately, technology stocks, which make up a large component of the indices, are experiencing serious gyrations as on the one hand their earnings growth continues to look extremely robust (and potentially insulated from an industrial slowdown), but on the other hand vulnerable to the imposition of draconian regulation. On both counts volatility is likely to continue but, looking through all the 'noise', the fundamental economic data remains strong and is reflected in continually rising earnings expectations which in turn underpin equity valuations. There is very little to indicate that an economic / earnings reversal is imminent. The more pressing debate is sector leadership. Given our economic outlook, we are not tempted to buy into defensive sectors like utilities or consumer staples; however, banks could look more interesting if interest rates continue to rise, and energy plays (i.e. not just oil stocks, but oil services companies like Schlumberger) will have an important role in a world of resource nationalism and continued emerging market recovery.

However, the risk of a trade war is overstated and, if the economic recovery continues, equities are reasonable value.

AAP

TOTAL RETURN INDICES TO 31ST MARCH 2018

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	0.2%	2.2%	1.8%	0.5%
Citigroup World Govt Bond Index	-1.2%	-1.0%	-2.4%	-3.3%
MSCI United Kingdom All Cap Index	-6.9%	-2.3%	-0.1%	1.2%
MSCI United Kingdom Index	-7.3%	-2.8%	-1.0%	-0.2%
MSCI AC World Index	-4.5%	0.1%	2.0%	2.4%
MSCI AC World (ex UK) Index	-4.3%	0.3%	2.2%	2.5%
MSCI AC World (ex US) Index	-4.7%	-0.8%	2.0%	3.9%
US Dow Jones Industrial Average	-5.5%	4.0%	6.4%	6.4%
S&P Composite Index	-4.3%	1.2%	2.4%	1.6%
MSCI Europe (ex UK) Index	-4.8%	-4.7%	-1.3%	3.0%
Tokyo TOPIX Index	-2.6%	4.9%	6.2%	8.2%
MSCI AC Asia Pacific ex Japan Index	-4.1%	2.6%	5.2%	7.6%
Waverton Growth Index	-3.4%	0.4%	1.8%	2.1%
Waverton Growth UK Bias Index	-3.9%	-0.1%	1.4%	1.9%
Waverton Balanced Index	-2.8%	0.6%	1.7%	1.9%
Waverton Balanced UK Bias Index	-3.2%	0.2%	1.4%	1.7%
Waverton Cautious Index	-2.2%	0.7%	1.5%	1.7%
Waverton Defensive Index	-1.6%	0.7%	1.3%	1.4%
Return on Cash £ (1 month deposit rate)	0.1%	0.2%	0.3%	0.4%
Inflation - UK CPI	0.3%	0.7%	1.5%	2.3%
Gold Price (£943.42)	-2.1%	-1.4%	-1.4%	-5.4%
£ vs US$	3.7%	4.6%	8.0%	12.2%
£ vs Euro	1.2%	0.5%	0.2%	-2.4%
£ vs Yen	-2.1%	-1.2%	2.2%	7.1%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	-1.2%	-1.1%	-0.7%	0.5%
Citigroup World Govt Bond Index	2.5%	3.6%	5.4%	8.5%
MSCI United Kingdom All Cap Index	-3.5%	2.1%	7.9%	13.5%
MSCI United Kingdom Index	-3.9%	1.6%	6.9%	11.9%
MSCI AC World Index	-1.0%	4.7%	10.1%	14.8%
MSCI AC World (ex UK) Index	-0.8%	4.9%	10.3%	15.0%
MSCI AC World (ex US) Index	-1.2%	3.8%	10.2%	16.5%
US Dow Jones Industrial Average	-2.0%	8.8%	14.9%	19.4%
S&P Composite Index	-0.8%	5.8%	10.6%	14.0%
MSCI Europe (ex UK) Index	-1.2%	-0.4%	6.6%	15.5%
Tokyo TOPIX Index	1.0%	9.7%	14.7%	21.4%
MSCI AC Asia Pacific ex Japan Index	-0.6%	7.3%	13.7%	20.7%
Waverton Growth Index	-0.9%	3.5%	7.6%	11.4%
Waverton Balanced Index	-0.9%	2.7%	6.1%	9.4%
Waverton Cautious Index	-0.9%	1.9%	4.6%	7.4%
Waverton Defensive Index	-0.7%	1.5%	3.6%	5.8%
Return on Cash $ (1 month deposit rate)	0.4%	0.7%	1.0%	1.3%
Inflation - US CPI	0.9%	0.9%	1.6%	2.1%
Gold Price ($1323.43)	1.5%	3.1%	6.4%	6.1%
US$ vs £	-3.6%	-4.4%	-7.4%	-10.9%
US$ vs Euro	-2.4%	-3.9%	-7.3%	-13.0%
US$ vs Yen	-5.6%	-5.5%	-5.3%	-4.6%

* All MSCI benchmarks are net of tax

Source: Thomson Reuters DataStream

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