MARKET PERSPECTIVES

JULY 2019

THE LAST QUARTER...

- Stocks and bonds advance; gold bullion rises 9%, closing at $1,412.
- Continental European stock markets lead the way, up 5.8% in US dollar terms; Emerging Markets lag, up just 0.6%.
- Hong Kong overtakes Japan to become the world's third largest stock market, behind the US and China.
- The UK government sells a 30-year bond at a record low yield: 1.42%.
- A Japanese consumer loan company issues a junk bond at a yield below 1%.
- The $12 billion Saudi Aramco bond issue is ten times oversubscribed.
- $13 trillion of bonds globally trade at a negative yield.
- UK unemployment falls to 3.8%, but sterling is weak – down nearly 4% on a trade-weighted basis.

"Money is gold; nothing else is."

J.P. Morgan, testifying before Congress, 1912

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Bond yields fall so low...

We have in this column written on many occasions about the impact of record low interest rates, and how this means government bonds are becoming even more vulnerable to price falls. The last three months have seen yet another fall in yields: the US 10-year treasury yield ended the quarter at 2.0% and the UK 10-year gilt closed at just 0.8% – both their lowest levels since 2016 and in former times unimaginable to any rational lender. This has not been confined to supposedly 'risk free' credits: corporate bond yields have also fallen, with so-called junk yields near all-time lows, both in absolute terms and relative to the equivalent government bond. This is difficult to rationalise: extraordinarily low government bond yields imply the expectation of weak economic growth, if not outright recession, which in turn would suggest that poor credits will be risky (meaning that junk bond yields should be higher). Alternatively, record low corporate bond yields imply a healthy economy – in which case, a pick-up in inflation must be a risk and government bond yields are surely too low.

...that large sections of the market carry negative yields.

Many investors are clearly prepared to tolerate negative real returns in exchange for the secure knowledge that the absolute return from bonds will nonetheless not be negative – in other words their capital is safe. Such risk aversion may not be to everybody's taste, but it is at least explainable. However, the situation has now become so extreme that trillions of dollars of bonds globally are now trading at negative actual yields, meaning that anyone who holds them knows that they will almost certainly lose money. Waverton clients will not be surprised to hear that we do not consider negative yielding bonds to be a sensible investment, but the increasing prevalence of the phenomenon and the impact which ultra-low yields have across the spectrum of the entire fixed interest asset class (and arguably all assets, which are ultimately priced off bond yields) means that we cannot merely dismiss it as madness or a mere quirk of the system which will magically disappear.

The gold price is appreciating.

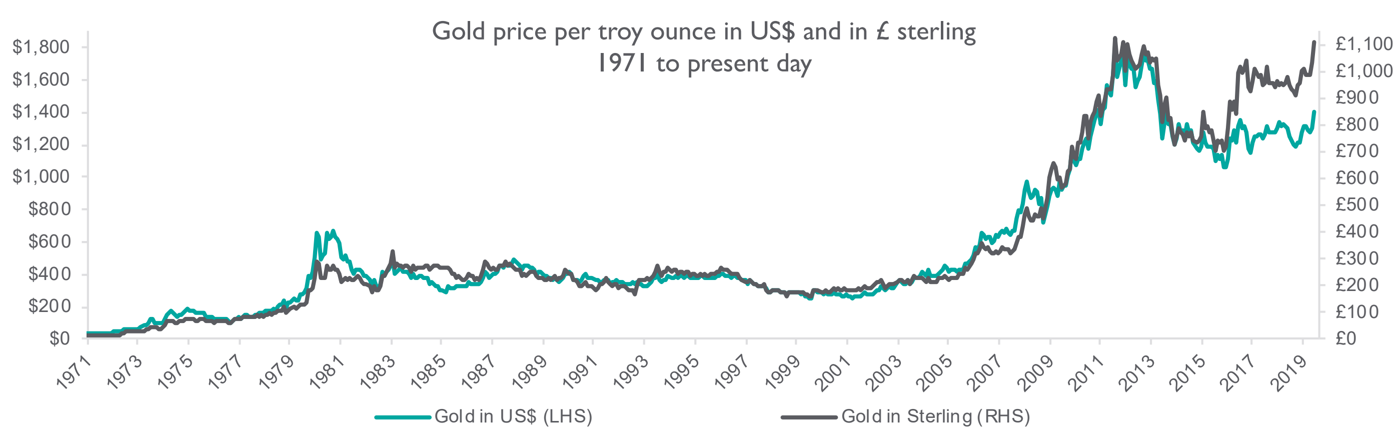
All this may go some way towards explaining why the gold price has broken out of its trading range. Investors searching for a safe haven have since time immemorial considered gold to be store of value – but the problem in recent times has been the volatility of the gold price day-to-day and the opportunity cost of holding something that doesn't produce an income. Both of these deterrents are somewhat counteracted in an ultra-low interest rate environment: firstly, the opportunity cost of gold disappears if bonds yield nothing either; secondly, low coupon bonds are vulnerable to price volatility and therefore lose the edge that fixed interest securities had over gold in that respect. By way of example, if the 30 year gilt yield rose from the present level of 1.5% to 3% over the next two years, the price of the gilt would fall by 27%. As an aside, we have just witnessed the longest lasting drawdown in gilts in over 40 years: it took anyone who bought the iBoxx Sterling Gilt Index gilt on 11th August 2016 953 days to get their money back. Gold as a safe haven has one major advantage over bonds: you can't print it at will. The supply of government debt has ballooned in recent years but gold supply has hardly moved; the total outstanding market capitalisation of gold exchange-traded funds only amounts to 0.15% of the value of outstanding government debt. Combine these fundamentals with geopolitical tensions in the Strait of Hormuz and the Korean peninsula and you have the conditions for a gold price spike.

Gold looks like a better alternative than government bonds.

Gold will continue to look relatively attractive if bond yields fall as the opportunity cost / volatility comparisons between the two asset classes continue to narrow; conversely, it will likely fall back in the short term if the global economy improves and interest rates move up again. Longer term, however, it may be that gold becomes much more widely and permanently accepted as a means of dampening portfolio volatility: if the next recession results in massive fiscal easing and the end of 'austerity', government paper, including old fashioned cash, will surely look even less attractive by comparison than it is now. John Pierpont Morgan, the great American financier, opined that only gold can be considered true money, everything else being merely a credit note.

Perhaps cryptocurrencies will go mainstream as well?

We note that cryptocurrencies have also taken the limelight recently: Bitcoin is up 200% since the end of March (though still well below its peak) and Facebook has announced the launch of Libra. Some of the arguments for gold, for example its limited supply, also apply to Bitcoin; on the other hand, like fiat money, cryptocurrencies are also fundamentally just a form of intangible promissory note, but with highly uncertain value. One doubts that J. P. Morgan would classify them as money if he were alive today but it may be that, as blockchain becomes 'mainstream', cryptocurrencies eventually become a more reliable unit of exchange than fiat money backed by unreliable and profligate governments. If that scenario did arise, then they would perhaps give gold a run for its money.



Source: Bloomberg Finance LP

OUTLOOK FOR EQUITIES

Earnings have been downgraded again...

As was the case during the first quarter of the year, equity markets have continued to appreciate in spite of growing evidence of economic slowdown and earnings downgrades. The aggregate forecast earnings growth for 2019 is now just 2.4%, down from 6.7% at the end of March. These figures are expressed in terms of the US dollar; in terms of sterling, a weak currency, the figure is 8.1% earnings growth expected this year. Forecasts for 2020 have been coming down as well, but analysts are still forecasting over10% earnings growth next year, which looks too optimistic given the present sluggishness. The main reason that markets appear to be sanguine on this subject has been the continued collapse in interest rate expectations. Three rate cuts by the US Federal Reserve are now expected by the end of the year, and there are increasing noises from the European Central Bank that they are prepared to act in order to maintain growth.

... as tariffs start to stifle trade.

There is some optimism that the US / China trade war can be halted before it becomes too damaging, but whether this is a triumph of hope over experience remains to be seen; in the meantime, world trade is flatlining at best, and manufacturing is in the doldrums, especially in Europe. The UK economy probably contracted slightly in the second quarter as Brexit-related stockpiling during the first quarter unwound. Asia, including Japan, is uniquely vulnerable to a tariff war – not only owing to its geographical proximity to China but because of its greater manufacturing bias than the west. We continue to find interesting stock ideas in Japan and a lagging Tokyo stock market presents us with increasingly good value, although it is extremely important that we maintain our disciplined investment criteria because that should prevent us from taking on undue cyclicality or investing in low quality companies – both of which have long been a risk in Japan and mistakes on that front would result in considerable pain if it turns out that the world really is going into recession.

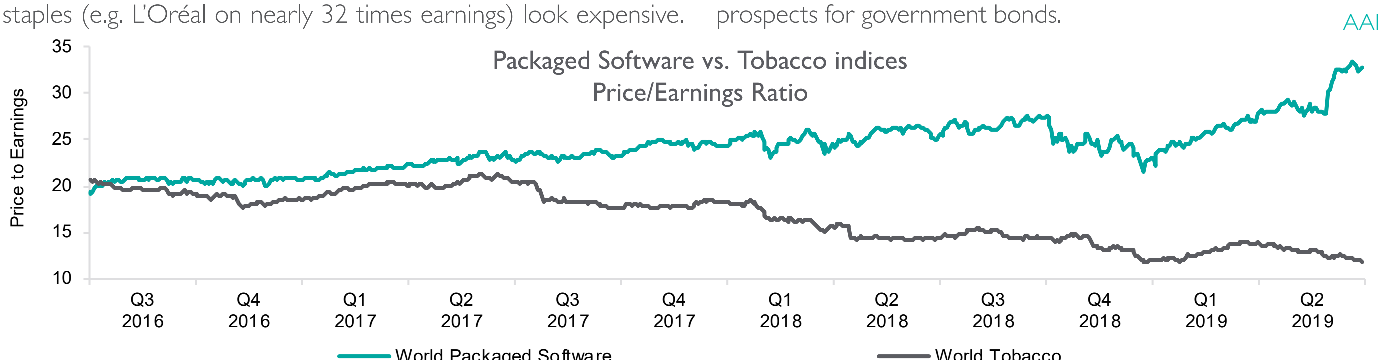
Valuations in the stock market are becoming polarised.

Despite the gains made so far this year, stock markets in aggregate don't look especially expensive on 15 times the next 12 months' earnings. However, this masks an increasingly difficult dynamic beneath the surface. Sectors which are under pressure for one reason or another have got much cheaper: for example, tobacco (see chart below), retail property (where Hammerson trades on a 60% discount to its estimated current NAV), European banks (valued at just 0.8 times book value) and most industrials (especially in the automobile sector, which is on only 8 times earnings). Conversely, long-term growth stocks like those in the software sector (which is on 25 times earnings) and defensive consumer staples (e.g. L'Oréal on nearly 32 times earnings) look expensive. Good long term compounders on reasonable valuations are no longer easy to find and it feels as though investors are being forced to choose between either taking on operational risk (i.e. buying into cheap companies where the outlook is uncertain) or accepting valuation risk (i.e. buying highly rated growth stocks which will see significant price volatility if they even have a mild short term upset). In reality, we construct our portfolios with a sensible mix of growth stocks and cheaper prospects – but at all times we strive to maintain our focus on cash flow and the fundamental sustainability of the business model rather than allowing ourselves to be sucked into structurally declining companies on the basis of superficially attractive valuations. We believe it is better to take on a degree of operational risk in potentially cyclical companies that we have researched well than to hide in areas which are widely considered to be ultra-defensive (and are consequently a 'crowded trade') – but which may in fact be more risky than is widely supposed (for example branded consumer staples vulnerable to margin pressure from generic upstarts or Chinese competitors).

Efficient diversification requires a suite of different solutions.

The key to generating good long term returns is to invest in productive assets, preferably by identifying companies which have a 'moat' around their business model which enables them to continue producing high returns on capital over a period of many years. Whilst so-called 'value' plays (i.e. optically cheap shares in sectors which are out of fashion) also have a role in portfolios from time to time, a more effective way to diversify risk away from equity market volatility has conventionally been to buy some fixed-interest exposure. Whilst bonds in themselves are not productive assets because the return from them is simply a promise to repay a set amount, the ability of a borrower to meet his / her commitment is ultimately contingent upon the ability of the enterprise behind the bond to produce a return. This is something which our corporate credit analysts never lose sight of and why we feel that is important that their research dovetails with that of our equity analysts. Given that focus on long-term productivity, it should be no surprise that we are increasingly wary of government bonds as an efficient way of diversifying away equity risk on anything other than a short-term basis. Gold has its attractions, but in the long run it too is an unproductive asset, albeit with some intrinsic value. Portfolio insurance (such as the Waverton Protection Strategy) can be effective, but costs real money. Property and infrastructure etc. (as found in the Waverton Real Assets Fund) have the advantage of being not only diversifiers but also productive assets in their own right – but they will not be able to escape correlation with the equity market in a severe downturn. In short, nothing is perfect, but we do at least have some tools in our armoury to deal with polarisation in the equity market and the downright poor prospects for government bonds.

AAP



Source: Factset, Waverton, 04.07.19

TOTAL RETURN INDICES TO 30th JUNE 2019

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	1.4%	5.0%	7.2%	5.2%
Bloomberg Barclays Global Aggregate Bond Index	5.8%	5.6%	9.5%	9.8%
MSCI United Kingdom All Cap Index	3.1%	13.1%	1.1%	0.3%
MSCI United Kingdom Index	3.3%	13.0%	2.1%	1.6%
MSCI AC World Index	6.1%	16.3%	3.9%	9.7%
MSCI AC World (ex UK) Index	6.2%	16.5%	4.0%	10.2%
MSCI AC World (ex US) Index	5.4%	13.7%	3.1%	5.1%
S&P Composite Index	6.8%	18.6%	5.0%	14.5%
MSCI Europe (ex UK) Index	8.3%	17.0%	4.1%	7.3%
MSCI Japan	3.4%	7.8%	-5.3%	-0.6%
MSCI AC Asia Pacific ex Japan Index	3.1%	12.3%	4.8%	4.6%
MSCI Emerging Markets	3.0%	10.7%	4.8%	5.0%
Waverton Growth Index	4.9%	13.1%	4.2%	8.4%
Waverton Growth UK Bias Index	4.2%	12.4%	3.6%	6.3%
Waverton Balanced Index	4.2%	11.3%	4.4%	7.6%
Waverton Balanced UK Bias Index	3.6%	10.7%	3.9%	5.9%
Waverton Cautious Index	3.4%	9.5%	4.5%	6.8%
Waverton Defensive Index	2.7%	7.5%	4.0%	5.6%
Return on Cash £ (1 month deposit rate)	0.2%	0.4%	0.5%	0.7%
Inflation - UK CPI	0.8%	0.8%	1.2%	2.0%
Gold Price (£1109.69)	11.6%	10.3%	21.5%	17.1%
£ vs US$	-2.3%	-0.1%	-2.4%	-3.6%
£ vs Euro	-3.7%	0.3%	-0.5%	-1.2%
£ vs Yen	-4.9%	-1.9%	-7.4%	-6.2%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	3.1%	5.3%	8.1%	7.3%
Bloomberg Barclays Global Aggregate Bond Index	3.3%	5.6%	6.8%	5.8%
MSCI United Kingdom All Cap Index	0.7%	13.0%	-1.3%	-3.3%
MSCI United Kingdom Index	0.9%	12.9%	-0.4%	-2.0%
MSCI AC World Index	3.6%	16.2%	1.4%	5.7%
MSCI AC World (ex UK) Index	3.8%	16.4%	1.5%	6.2%
MSCI AC World (ex US) Index	3.0%	13.6%	0.6%	1.3%
S&P Composite Index	4.3%	18.5%	2.5%	10.4%
MSCI Europe (ex UK) Index	5.8%	16.9%	1.6%	3.4%
MSCI Japan	1.0%	7.7%	-7.6%	-4.2%
MSCI AC Asia Pacific ex Japan Index	0.7%	12.2%	2.3%	0.8%
MSCI Emerging Markets	0.6%	10.6%	2.3%	1.2%
Waverton Growth Index	3.4%	13.4%	2.7%	6.0%
Waverton Balanced Index	3.2%	11.7%	3.5%	6.2%
Waverton Cautious Index	3.1%	10.1%	4.2%	6.4%
Waverton Defensive Index	2.7%	8.2%	4.1%	5.9%
Return on Cash $ (1 month deposit rate)	0.2%	0.4%	0.6%	0.7%
Inflation - US CPI	0.8%	0.8%	1.2%	2.0%
Gold Price ($1412.3)	9.0%	10.2%	18.5%	12.9%
US$ vs £	2.4%	0.1%	2.5%	3.7%
US$ vs Euro	-1.4%	0.4%	2.0%	2.5%
US$ vs Yen	-2.7%	-1.8%	-5.1%	-2.7%

* All MSCI benchmarks are net of tax

Source: Factset,Thomson Reuters DataStream

WAVERTON INVESTMENT MANAGEMENT LIMITED 16 BABMAES STREET LONDON SW1Y 6AH 020 7484 7484 WAVERTON.CO.UK

Registered in England Number 2042285. Authorised and Regulated by the Financial Conduct Authority