MARKET PERSPECTIVES

OCTOBER 2019

THE LAST QUARTER...

- Stock markets see mixed returns: Japan and the US are up, Asia and Emerging Markets down.
- Bonds continue to ride high: gilts return 6.5% as the 10-year yield hits an all-time low of 0.41%.
- The US Federal Reserve cuts rates for the first time in ten years.
- More than 7 renminbi are now required to buy one US dollar – a new low for the Chinese currency.
- Sterling hits a thirty-four year low; the Argentine peso falls 26%.
- Gold continues to appreciate – up 4.4%.
- Oil has its biggest intra-day rise since 1988 following a drone attack on Saudi Arabia.
- Amazon celebrates its 25th birthday.

"They defend their errors as if they were defending their inheritance."

Edmund Burke, *Speech on the Independence of Parliament* (1780)

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Negative bond yields are no longer an aberration.

Companies globally issued a record $308bn of bonds in the month of September. There seems to be no let-up in investor demand, even though yields are lower than ever. Indeed, $15 trillion of bonds around the world (including several trillion dollars of corporate paper) now carry a negative yield – in other words the lender has to pay interest to the borrower. Not all borrowers, of course, are able to arrange their finances on these 'Alice in Wonderland' terms, but outstanding stock on that scale means that the phenomenon has gone mainstream and is not confined to a few exceptionally high-grade credits. In fact, arguably the best credit of all, namely the US government, has to pay a higher rate of interest than almost any other creditworthy western nation or large corporation. It is difficult to imagine an environment where being a thoughtful and active investor is more important than blindly following indices; nor a worse time to be a passive investor in bond markets, allocating capital solely through the medium of exchange traded funds (ETFs). When a weightings-driven investment philosophy is applied to the fixed interest world it automatically directs funds towards the world's most indebted countries and companies; value based on long-term fundamentals, no matter how glaringly obvious, is disregarded.

There are a number of reasons for this.

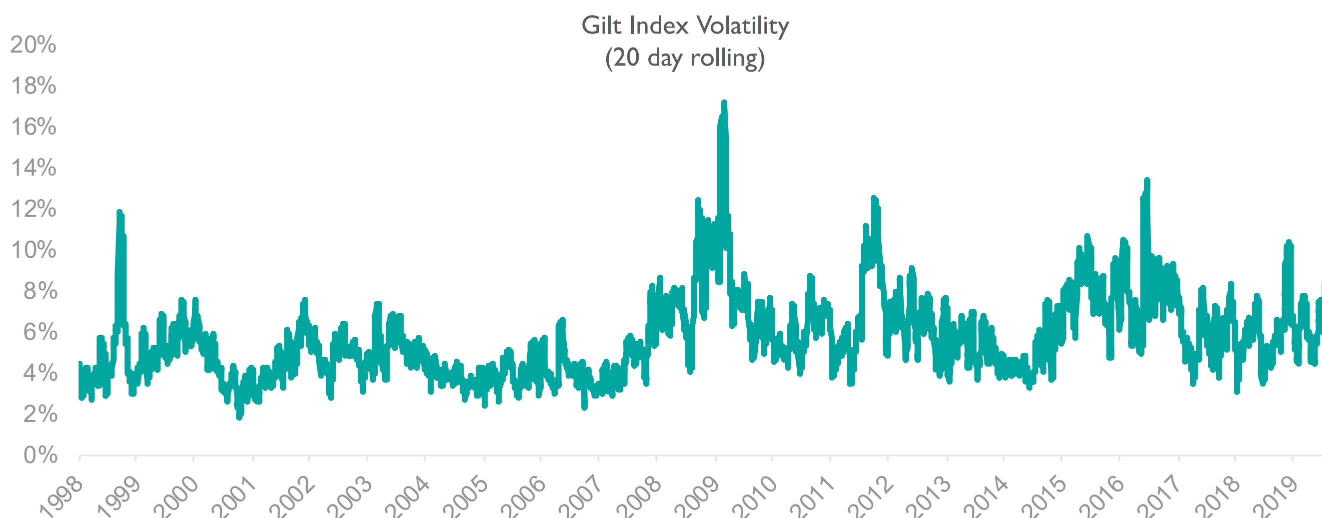
The US dollar may be the world's reserve currency, but there is no shortage of people willing to lend euros as well – despite the interest being lower (negative in many cases) and the long term value of the principal being more uncertain given the fundamentals of the Eurozone and the single currency. Euro denominated corporate bond sales already total €580bn so far this year – a record by some margin. The ready availability of free money means that the enthusiasm which governments and companies have for issuing bonds on these terms needs no explanation. However, the willingness of investors / lenders to tolerate such extremely low rates of return on their money is a phenomenon which will surely fascinate and baffle historians in equal measure. We have attempted to explain it in previous editions of *Market Perspectives.* Essentially, the culprits are: 1) the spasmodic fear of deflation (though all such scares in recent decades have so far failed to materialise to any meaningful degree), 2) the willingness of central banks to cut overnight rates to increasingly negative lows, consequently pulling bond yields down in sympathy, 3) a mammoth bond buying spree by central banks engaging in quantitative easing, 4) ingrained risk aversion among investors still scarred by the collapse of 2008/09, 5) forced buying of bonds regardless of value by life assurance companies which are compelled to follow the mantra of asset/liability modelling and by banks complying with new rules governing regulatory capital and 6) buying by unthinking or lazy passive investors through the medium of ETFs.

Strong companies can raise funds cheaply, but weak credits must pay dearly.

Readers may now conclude, given all the above, that being an active bond investor should be easy in this environment – simply a matter of steering well clear of negative yields and ETFs. Identifying what not to invest in is, of course, only half the battle. The universe of higher yielding bonds is getting smaller and finding decent quality credits which carry a reasonable coupon and ready liquidity is nearly impossible. The bond market is becoming polarised: good credits like Exxon Mobil and Apple have been able to issue dollar paper yielding around 2%; in euroland Met Life issued a bond with a 0% coupon, maturing in 2022 – for which investors were willing to pay slightly over par. Conversely, a number of more doubtful or cyclical companies in recent weeks have been forced to offer huge coupons to drum up investor demand (e.g. 12% for Aston Martin). Other companies, like Metro Bank, have been forced to pull their bond issues (though Metro Bank did manage to secure their financing after the end of the quarter at 9.5%). Moreover, not only is liquidity an issue throughout the bond markets, volatility has picked up, with the gilt index now showing its highest volatility since 2008. That is partly a function of the maths of low coupon bonds, but also a reflection of the growing risks surrounding this bubble.

Active management is essential.

Our bond funds are navigating this minefield with a mix of caution and imagination. Duration is, through hedging, kept low enough to minimise volatility and the risk of rising yields, income is derived from corporate paper (but with minimal exposure to high yield) and quasi-government issues like DP World (i.e. Dubai Ports), and the liquidity issue is addressed through diversification across 80 or so holdings. All this is covered by a currency overlay to ensure that individual bond returns are not wiped out by adverse foreign exchange movements.



Source: Bloomberg

OUTLOOK FOR EQUITIES

Equities are facing an earnings headwind...

Equity markets have been surprisingly resilient in the face of a definite economic slowdown. A major reason for that is the degree to which equity valuations are underpinned by these ultra-low bond yields and falling short rates. However, equities will not be able to defy gravity if earnings undergo a sustained reversal. At the beginning of this year analysts were expecting total earnings growth on the world index of 9.5% in 2019; now the expectation is for -0.6%. Whilst an element of this is accounted for by the strength of the US dollar (i.e. the earnings downgrade is not so severe when looked at in terms of other currencies), the fact remains that the economic fundamentals have been deteriorating all year as global trade and European manufacturing have gone into reverse. Furthermore, market sentiment is being aggravated by the ongoing US / China trade war, a potentially disruptive Brexit and unrest in Hong Kong.

...and the economic outlook is mixed.

Whilst some recessionary indicators are flashing red (e.g. the inverted yield curve and a decline in aggregate US corporate profits), other factors, like a falling oil price and relatively calm credit markets, are helpful. America and China are the big swing factors. It is often said, "When the US sneezes, the rest of the word catches a cold" – reflecting the fact that the US is such a large proportion of the global economy. However, China is now arguably as important: it makes up 16% of the world economy and, according to the IMF, will account for 30% of global GDP growth this year. The old adage may have to be updated to reference sneezing among the hog population in China because soaring pork prices on the back of an outbreak of swine fever will have a potentially quite significant knock-on effect on Chinese consumer expenditure. This comes at a time when China's auto sector is under pressure and newly imposed trade tariffs are expected to constitute a direct hit to GDP of c. 1%. Accordingly, Chinese GDP growth this year will likely be just 6.2%, which would be the weakest number since the early 1990s.

Europe is vulnerable.

Weakness in Europe is also a concern, but slow growth there has been endemic for some time and, in the absence of a specific catalyst such as a 'no deal' Brexit, is unlikely to be a cause of a more widespread global downturn. Instead, ill winds from Asia or America will amplify Europe's manufacturing downturn. Against this backdrop, Europe can ill afford a trade war with America or a disruptive Brexit, and the ability of the Eurozone to adapt to these challenges must be called into question when interest rates are already -0.5%, strict fiscal rules preclude fiscal stimulus and the single currency has locked so many diverse economies into the same regime.

America and China are likely to be the swing factors.

In contrast, both America and China do have levers they can pull – not least curtailing their trade war. Aside from that, the US has the scope to cut interest rates, and has already done so twice. China can stimulate lending in its economy directly through its state-owned banks and can encourage more urbanisation by freeing up land for development and flexing the Hukou system through which the state controls the population's entitlement to benefits. The government's restrained reaction to date indicates that it sees the present economic weakness as temporary. For our part, the companies operating in China that we have seen aren't unduly gloomy and, whilst there are pockets of weakness, there is nonetheless strength in other areas such as the healthcare, technology and high-end consumer sectors. The situation in Hong Kong is obviously a worry, but we take comfort from the fact that hitherto the Chinese authorities have chosen to be quite restrained and the protesters, far from arguing for a revolution which would threaten the Chinese state, are essentially demanding a reversion to the *status quo ante* in Hong Kong. That may not be realistic twenty two years into a fifty year process of handing over full sovereignty to China, but the history of past crises in Hong Kong (e.g. SARS in 2003) is that it soon bounces back.

We have trimmed our overweight equity stance.

In summary, whilst we have reduced our equity exposure in recognition of the tough earnings outlook, we are not yet sufficiently concerned about the fundamentals or nervous of valuations to advocate a wholeheartedly underweight position in what we maintain is the best asset class in which to deploy long-term capital.

AAP

Source: China Ministry of Commerce

TOTAL RETURN INDICES TO 30TH SEPTEMBER 2019

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	6.5%	8.0%	11.8%	14.2%
Bloomberg Barclays Global Aggregate Bond Index	4.0%	10.0%	9.9%	13.9%
MSCI United Kingdom All Cap Index	0.9%	4.0%	14.1%	2.0%
MSCI United Kingdom Index	0.7%	4.0%	13.8%	2.8%
MSCI AC World Index	3.3%	9.5%	20.1%	7.3%
MSCI AC World (ex UK) Index	3.4%	9.8%	20.4%	7.5%
MSCI AC World (ex US) Index	1.4%	6.9%	15.3%	4.5%
S&P Composite Index	5.0%	12.2%	24.6%	10.3%
MSCI Europe (ex UK) Index	1.7%	10.2%	18.9%	5.8%
MSCI Japan	6.5%	10.2%	14.8%	0.9%
MSCI AC Asia Pacific ex Japan Index	-0.8%	2.3%	11.4%	4.0%
MSCI Emerging Markets	-1.1%	1.9%	9.4%	3.7%
Waverton Growth Index	3.2%	8.2%	16.7%	7.5%
Waverton Growth UK Bias Index	2.8%	7.1%	15.5%	6.4%
Waverton Balanced Index	3.3%	7.6%	15.0%	7.8%
Waverton Balanced UK Bias Index	2.9%	6.6%	14.0%	6.9%
Waverton Cautious Index	3.4%	6.9%	13.1%	8.0%
Waverton Defensive Index	2.9%	5.7%	10.6%	7.0%
Return on Cash £ (1 month deposit rate)	0.2%	0.4%	0.5%	0.7%
Inflation - UK CPI	0.5%	1.3%	1.2%	1.7%
Gold Price (£1196.02)	7.8%	20.3%	18.9%	30.9%
£ vs US$	-3.2%	-5.4%	-3.2%	-5.5%
£ vs Euro	1.1%	-2.6%	1.5%	0.7%
£ vs Yen	-2.9%	-7.7%	-4.7%	-10.1%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	2.5%	5.7%	8.0%	10.8%
Bloomberg Barclays Global Aggregate Bond Index	0.7%	4.0%	6.3%	7.6%
MSCI United Kingdom All Cap Index	-2.3%	-1.6%	10.4%	-3.6%
MSCI United Kingdom Index	-2.5%	-1.6%	10.1%	-2.9%
MSCI AC World Index	0.0%	3.6%	16.2%	1.4%
MSCI AC World (ex UK) Index	0.1%	3.9%	16.5%	1.6%
MSCI AC World (ex US) Index	-1.8%	1.1%	11.6%	-1.2%
S&P Composite Index	1.7%	6.1%	20.6%	4.3%
MSCI Europe (ex UK) Index	-1.5%	4.2%	15.1%	0.0%
MSCI Japan	3.1%	4.2%	11.1%	-4.7%
MSCI AC Asia Pacific ex Japan Index	-4.0%	-3.3%	7.8%	-1.8%
MSCI Emerging Markets	-4.2%	-3.7%	5.9%	-2.0%
Waverton Growth Index	0.5%	3.8%	13.9%	3.2%
Waverton Balanced Index	0.8%	4.0%	12.6%	4.3%
Waverton Cautious Index	1.1%	4.2%	11.3%	5.4%
Waverton Defensive Index	1.1%	3.8%	9.4%	5.3%
Return on Cash $ (1 month deposit rate)	0.6%	1.2%	1.8%	2.4%
Inflation - US CPI	0.4%	0.9%	1.4%	1.7%
Gold Price ($1473.85)	4.4%	13.7%	15.0%	23.7%
US$ vs £	3.3%	5.7%	3.4%	5.8%
US$ vs Euro	4.5%	3.0%	4.9%	6.5%
US$ vs Yen	0.3%	-2.4%	-1.5%	-4.9%

* All MSCI benchmarks are net of tax

Source: Factset,Thomson Reuters DataStream

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