MARKET PERSPECTIVES

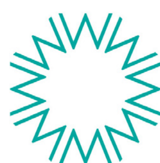
JULY 2018

THE LAST QUARTER...

- World stock markets recover strongly from the January-March falls, led by the UK, which experienced its best quarter since 2013 – up 9.4% including dividends.
- The FTSE100 experiences seven consecutive weeks of gains.
- Government bond returns are largely dictated by currency movements – i.e. chiefly a strong US dollar and weak sterling. The dollar gains 6.3% against sterling, and 5.3% against the euro.
- Political crisis in Italy causes Italian bonds to suffer their worst day in 26 years.
- Emerging markets underperform and see significant fund outflows.
- The Shanghai Composite index enters official 'bear market' territory – down over 20% from its January peak.
- General Electric Co., one of the original constituents of the Dow Jones Industrial Average in 1896, leaves the index. It is replaced by Walgreens Boots Alliance – just as Amazon buys PillPack.

"The best way to destroy the capitalist system is to debauch the currency."

V. I. Lenin (1870-1924)



WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Bond yields in the US have reached more sensible levels

We reported in the April edition of *Market Perspectives* that bond yields had risen during the first quarter of 2018, noting how uncomfortable this was for fund managers who rely on government bonds to provide diversification in balanced portfolios – given that equity markets were also declining at the time. Long-dated US treasury yields reached a peak of 3.25% in mid-May and then stabilised around 3%. We do feel that a yield above 3% is starting to look attractive: inflation in the US is running at c. 2.5%, so the long bond is offering a real return again, and we do not expect inflation to run out of control (though this is something that needs to be monitored carefully because tariffs are in the short term going to be unhelpful for consumer prices). Secondly, US government paper and the dollar as a currency generally do serve as safe havens when other assets are selling off, so treasuries continue to have some attraction in portfolio construction. We made good use of long-dated treasuries in 2016 during the Brexit referendum and Donald Trump's election, and they remain an important tool in our armoury.

Some emerging markets bond yields have soared...

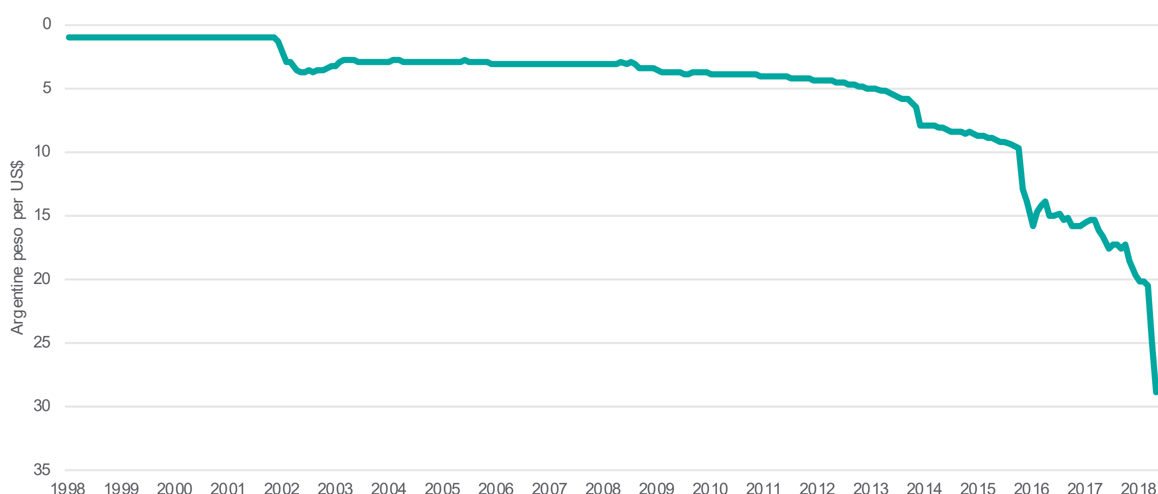
We have recently been reminded that for a government bond to be thought of as a safe investment one not only needs to consider its price relative to par value, the prevailing rate of inflation and the creditworthiness of the government concerned: one must also examine the outlook for the currency. These factors are, of course, interlinked. Two years ago we noted in *Market Perspectives* that Argentina had issued its first hard currency government bond for 15 years. This is a country which has defaulted on its debts eight times since it gained independence in 1816, and which has been a serial devaluer of its currency. Since the peg with the US dollar broke in 2002, the peso has declined 97% (see chart below). So far this year the peso is down 36% against the US dollar and the ten-year government bond yield has risen from 5.6% to 9.0%. Investors who bought that Argentinian new issue in 2016 (denominated in US dollars, so in theory immune to fluctuations in the value of the peso) are now sitting on a capital loss of nearly 20%.

...as currencies have weakened.

Emerging markets generally have performed poorly in recent months – particularly those countries which have a lot of dollar denominated debt. This has affected both equity markets and currencies. The worst cases have been very country specific – e.g. the Turkish devaluation on the back of a growing current account deficit, high levels of foreign debt and an increasingly nationalistic government. Across Asia, there has been a more general malaise which is not only attributable to the rising US dollar (which impacts the competitiveness of currencies linked to the dollar) but also the emerging trade war with the US, which clouds the outlook for the whole region as an important manufacturing centre. There are some concerns that China will materially devalue the renminbi (Rmb) in response to the United States' imposition of broad-based tariffs: the currency is already off over 5% against the dollar since February, and down 9% on the all-time high reached in 2014.

European bond markets remain vulnerable.

The outlook for the euro has also become topical again thanks to profound disagreements across the continent about where the currency bloc stands on free movement of people, debt mutualisation, trade policy in reaction to American tariffs and defence in the face of the ongoing threat from Russia. Brexit is a somewhat parochial issue in comparison with the arguments reverberating across the Continent about migration and the profound differences in outlook between the elected leaders of Germany, France and Italy. Italy's 'Target 2' liabilities (i.e. effectively what its central bank owes other Eurozone central banks) are enough to make any emerging market currency board member blanch and will remain a source of potential instability for the foreseeable future. If history is any guide, such imbalances can only be resolved through currency devaluation or default, so it is hardly surprising that the Italian bond market took fright when people took office who had apparently endorsed Italy leaving the Eurozone, and are considering issuing a parallel domestic currency – rather in the same vein as various incarnations of the Argentine peso over the years.



Source: Bloomberg, Waverton

OUTLOOK FOR EQUITY MARKETS

In May, the index provider MSCI announced the addition of 'A' shares listed in mainland China and thereby increased China's weighting in the emerging market index. Previously only Chinese companies listed in Hong Kong ('H' shares), those listed in the USA (ADRs) and the very limited 'B' share market (mainland-listed shares denominated in foreign currencies) had been included. China 'A' shares, which are denominated in Rmb, have to a large extent been closed to foreign investors, but Waverton is applying for a licence which will enable us to participate in that market directly. Historically, 'A' and 'B' shares have looked somewhat unattractive relative to 'H' shares and ADRs as levels of disclosure and corporate governance were inferior and, where companies were listed both domestically and internationally, the 'A' & 'B' shares commanded a 50-60% valuation premium because excess saving from Chinese investors inflated domestic prices on that narrow market. However, as the Chinese economy liberalises and the stock market opens up to international investors, 'A' & 'B' shares are becoming more investable.

China's weighting in the indices is increasing...

There has been some concern in the second quarter of this year about a Chinese economic slowdown. Weakness in the Li Keqiang index in the Spring caught our intention. This indicator was created by *The Economist* newspaper and is based on a remark once made by Chinese Premier Li Keqiang to a US diplomat that China's GDP data was 'man made' and that to monitor economic growth he looked at the change in bank lending, rail freight and electricity consumption – which is what this index now tracks. Anything that presages a downturn in China has an immediate impact on commodity prices and risk appetite in stock markets around the world. Not only is the Shanghai index now in a bear market, but the Hang Seng China Enterprises index of shares listed in Hong Kong is also down nearly 20% since January. The last time there was a growth scare in China, in 2015, this index halved in nine months – so it is understandable that investors were spooked and that seasoned China bears are again highlighting Chinese debt levels.

...but share prices have fallen nonetheless.

The ongoing trade spat with the US brings the issue of China risk to the fore once again. The declining value of the Rmb, bank loan write-offs and a certain amount of capital flight have all added grist to the mill. It is therefore slightly odd that, against this background, commodity prices have not collapsed, nor have developed world equities been spooked to any great degree (which in the past they have been by any hint of a slowdown in China). It is notable that global stock markets have been led increasingly by the technology sector as the industrial element of the economy diminishes in importance. This is as true in China as it is in the US: Tencent, Alibaba and Baidu have a combined market capitalisation of almost $1trillion. Moreover, there are plenty of reasons to be optimistic on China, where the authorities have numerous tools with which to tackle any economic downturn. We feel that the much mooted devaluation of the Rmb is not one of those which will in practice be employed because it would conflict with China's long term aspiration of being home to a fully convertible reserve currency (quite apart from being a further provocation to the Trump administration). Measures which will continue to be used are a relaxation of banks' reserve requirement ratios and the state's manipulation of the Hukou system of household registration which governs the availability of social services and through which the movement of the population from the countryside to the cities can be controlled (which has the knock-on effect of massaging residential property prices). Indeed, social credit is now being used to promote societal and economic 'trustworthiness', rather in the manner of the 11th century Baojia system, which was partially revived by Chiang Kai-Shek in Republican times: China's elite have a centuries long track record of maintaining a social contract which keeps the population politically acquiescent in return for economic advantage. It is no coincidence that Chinese unemployment has remained between 4.0% and 4.3% for nearly fifteen years; it is now 3.9%. President Xi Jinping's recent lifetime appointment affirms that the country's leaders like to play a long game.

However, the fundamentals remain strong and...

Perhaps another explanation for this year's decline in the Chinese stock market index is merely that expectations had got ahead of themselves as investors anticipated MSCI's increase in China's weighting in their index. That is an all too frequent problem with major index changes but one that, as active managers, we only take a passing interest in.

...we continue actively to look for ideas.

AAP

Source: Bloomberg, Waverton

TOTAL RETURN INDICES TO 30TH JUNE 2018

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	0.2%	0.4%	2.4%	2.0%
Citigroup World Govt Bond Index	2.7%	1.5%	1.7%	0.3%
MSCI United Kingdom All Cap Index	9.3%	1.7%	6.7%	9.2%
MSCI United Kingdom Index	9.4%	1.4%	6.3%	8.2%
MSCI AC World Index	6.8%	2.0%	7.0%	8.9%
MSCI AC World (ex UK) Index	6.7%	2.1%	7.0%	9.0%
MSCI AC World (ex US) Index	3.5%	-1.4%	2.7%	5.5%
US Dow Jones Industrial Average	7.6%	1.7%	11.9%	14.4%
S&P Composite Index	9.9%	5.2%	11.2%	12.5%
MSCI Europe (ex UK) Index	3.2%	-1.7%	-1.6%	1.8%
Tokyo TOPIX Index	3.1%	0.4%	8.1%	9.5%
MSCI AC Asia Pacific ex Japan Index	2.4%	-1.8%	5.1%	7.8%
Waverton Growth Index	5.1%	1.5%	5.5%	7.0%
Waverton Growth UK Bias Index	5.6%	1.5%	5.6%	7.1%
Waverton Balanced Index	4.1%	1.2%	4.7%	5.8%
Waverton Balanced UK Bias Index	4.5%	1.1%	4.7%	5.9%
Waverton Cautious Index	3.0%	0.8%	3.8%	4.6%
Waverton Defensive Index	2.3%	0.6%	3.0%	3.6%
Return on Cash £ (1 month deposit rate)	0.1%	0.2%	0.4%	0.4%
Inflation - UK CPI	0.8%	0.8%	1.6%	2.4%
Gold Price (£947.65)	0.4%	-1.7%	-1.0%	-1.0%
£ vs US$	-5.9%	-2.4%	-1.6%	1.6%
£ vs Euro	-0.9%	0.4%	-0.4%	-0.7%
£ vs Yen	-2.0%	-4.0%	-3.2%	0.2%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	0.1%	-1.1%	-1.0%	-0.6%
Citigroup World Govt Bond Index	-3.4%	-0.9%	0.1%	1.9%
MSCI United Kingdom All Cap Index	2.8%	-0.7%	5.0%	11.0%
MSCI United Kingdom Index	2.9%	-1.0%	4.6%	10.0%
MSCI AC World Index	0.5%	-0.4%	5.3%	10.7%
MSCI AC World (ex UK) Index	0.4%	-0.4%	5.3%	10.8%
MSCI AC World (ex US) Index	-2.6%	-3.8%	1.0%	7.3%
US Dow Jones Industrial Average	1.3%	-0.7%	10.2%	16.3%
S&P Composite Index	3.4%	2.6%	9.5%	14.4%
MSCI Europe (ex UK) Index	-2.9%	-4.1%	-3.2%	3.5%
Tokyo TOPIX Index	-3.0%	-2.0%	6.4%	11.2%
MSCI AC Asia Pacific ex Japan Index	-3.6%	-4.2%	3.4%	9.6%
Waverton Growth Index	0.4%	-0.5%	3.9%	8.1%
Waverton Balanced Index	0.3%	-0.6%	3.0%	6.5%
Waverton Cautious Index	0.2%	-0.7%	2.1%	4.9%
Waverton Defensive Index	0.2%	-0.5%	1.7%	3.8%
Return on Cash $ (1 month deposit rate)	0.5%	0.9%	1.2%	1.5%
Inflation - US CPI	0.8%	2.1%	1.9%	2.7%
Gold Price ($1251.13)	-5.5%	-4.0%	-2.5%	0.6%
US$ vs £	6.3%	2.5%	1.6%	-1.6%
US$ vs Euro	5.3%	2.8%	1.3%	-2.3%
US$ vs Yen	4.2%	-1.7%	-1.6%	-1.4%

* All MSCI benchmarks are net of tax

Source: Factset,Thomson Reuters DataStream

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