Banque Havilland
Compass
First Quarter 2019

Contents

Market Environment

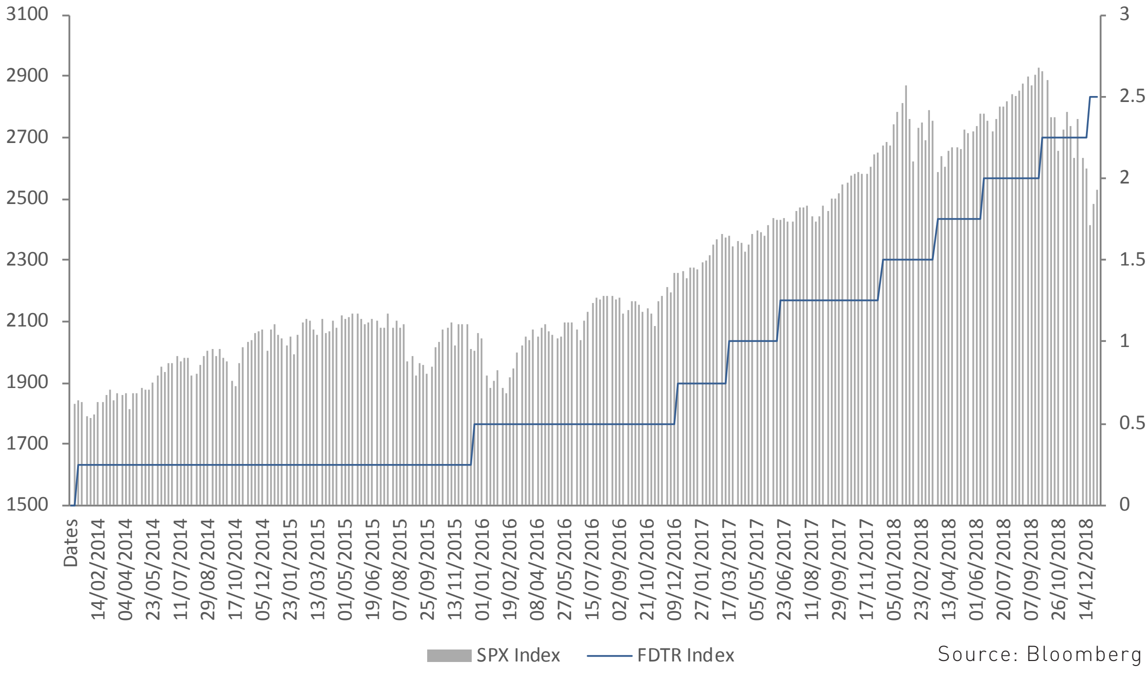
December turned out to be a fitting end to 2018 – a year that saw the calm in financial markets finally snap, and an end to the low volatility that investors have benefitted from in largely uninterrupted fashion since the financial crisis ten years prior. To paraphrase the Queen of England from her speech of 1992, this was not a year which market participants will look back with undiluted pleasure, and was very much an 'annus horribilis' as a Deutsche Bank report found that 93% of assets (in USD terms) lost money for investors in 2018, and by their measure it was in fact the worst year on record, eclipsing the 84% seen in 1920. As ever there have been plenty of geo-political stories for market commentators to pontificate over, and many of these remain unresolved as we move into the new year. In recent years these may have been digested by the markets in a couple of trading sessions before equity markets recommenced their uphill march (i.e. the UK referendum, Trumps election, North Korean nuclear threats etc), but since the start of October this is no longer the case – so what has changed? In several recent editions of this publication we have documented our concern over the prospect of tightening monetary policy in the major economy at a time that many asset prices had become increasingly stretched in terms of valuations, and this scenario was brought abruptly to the forefront of the markets consciousness as the Federal Reserve confirmed their commitment to their rate-rising agenda. Ironically, a President (that had on numerous occasions linked the surge in asset prices of the past two years to his own policies and success) found himself very publically criticising the FED, an action which in itself almost certainly caused the market to panic further, thus exacerbating the sell-off. Jerome Powell, the FED chairman has oft stated that the Reserve will not be influenced by the state of the financial markets, and this rhetoric has been and will be firmly tested by the current volatility, not to mention a belligerent Whitehouse. When he was appointed in charge of the FED on February 5th, the S&P 500 fell 4% on that day, perhaps an omen for what was to come and it was in fact probably the most significant single event of 2018 as far as the market was concerned. Quantitative Easing (printing of money to buy bonds) has largely been credited for the constant surge in asset prices since 2008, a policy followed by Europe and Japan as well of course, so when Powell joined the FED at a time that this policy is actually starting to be reversed it is little wonder that every phrase, eyebrow-raise and half-comment is pored over by the investment community. Although it does not make

ASSET CLASS		2018 RETURN %
Global Stocks	MSCI WORLD	-8.19
US Stocks	S&P 500 INDEX	-4.39
European Stocks	Euro Stoxx 50 Pr	-11.34
UK Stocks	FTSE ALL-SHARE INDEX	-9.51
Swiss Stocks	SWISS MARKET INDEX	-7.05
Japan Stocks	TOPIX INDEX (TOKYO)	-16.03
Emerging Market Stocks	MSCI EM	-14.49
Global Bonds	Global Aggregate	-1.20
European Bonds	Euro-Aggregate	0.41
UK Bonds	Sterling Aggregate	-0.13
Global Investment Grade Bonds	Liquid Investment Grade	-3.67
Global High Yield Bonds	Global High Yield	-4.06
Emerging Market Bonds	J.P. Morgan EMBI Global Total	-4.61
Gold and Silver	PHILA GOLD & SILVER INDEX	-16.41
Crude Oil	Generic 1st 'CL' Future	-24.84
Hedge Funds	Hedge Fund Research HFRC Global	-6.72

Most major asset classes registered significant losses in 2018. Source: Bloomberg for such exciting headlines such as Trump, Brexit, Les Gilets Jaunes, Italy v EU or Trade War, it is once again interest rates or concerns over which way they are moving that is dominating market sentiment.

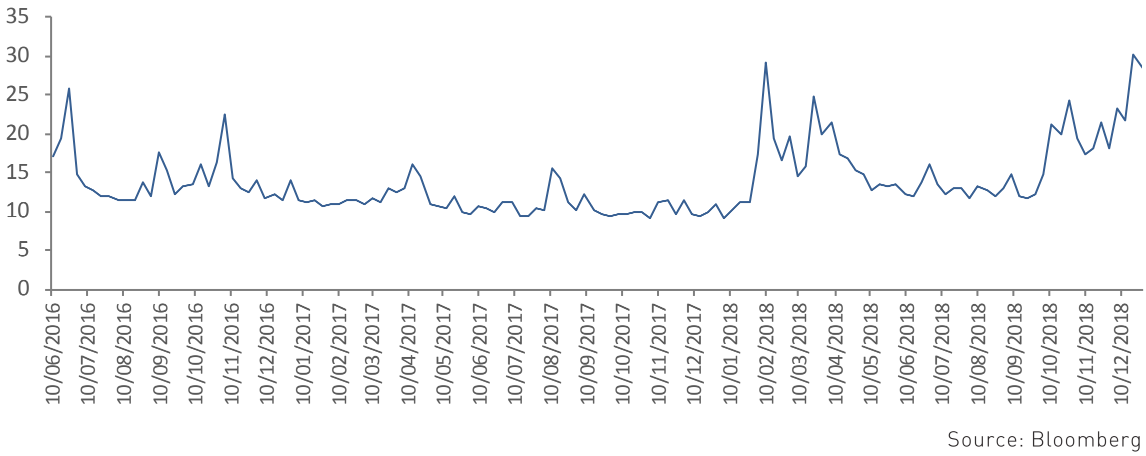
As mentioned it is not just Powell and the FED that are tightening policy – many other central banks are turning the liquidity taps off, with Mario Draghi announcing the end to QE in Europe in December (despite the slowing growth) and speculation growing that he will add one rate rise before he ends his term at the ECB. Ultimately, asset prices are driven by the amount of money flowing in to them, so when the amount of money is set to be less it is inevitable that the 'rising tide lifts all ships' environment we have seen since 2008 will have to end – which is precisely what we are seeing now. As such it becomes more important than ever for investors to be picky and choose only productive, robust assets to avoid the 'receding tide' as liquidity becomes thinner, and we believe that in the long term this is a good thing for discerning investors and for quality, low-debt assets. In practice this means an increasing bias to value and 'defensive' stocks in regions of the world that offer genuine, sustainable growth opportunities while holding bonds that do not compromise in terms of credit quality.

One rate-rise too many for equities?



At the end of 2018 the latest 2 rate hikes saw the S&P500 sell-off rapidly. A big fear for investors is that of a FED 'mis-step'...

Volatility (CBOE VIX Index)

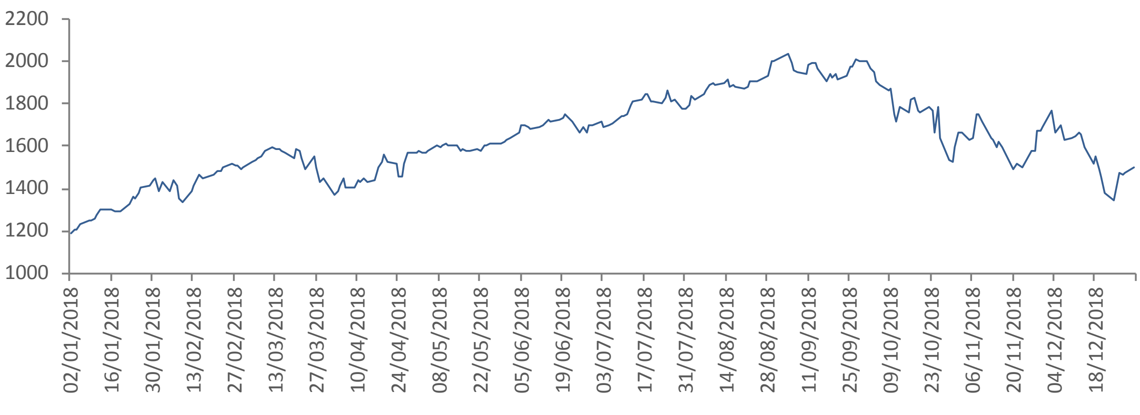


Volatilty spiked at the end of 2018 as stocks markets sharply corrected - contrast with 2017 where volatility was calm.

EQUITIES

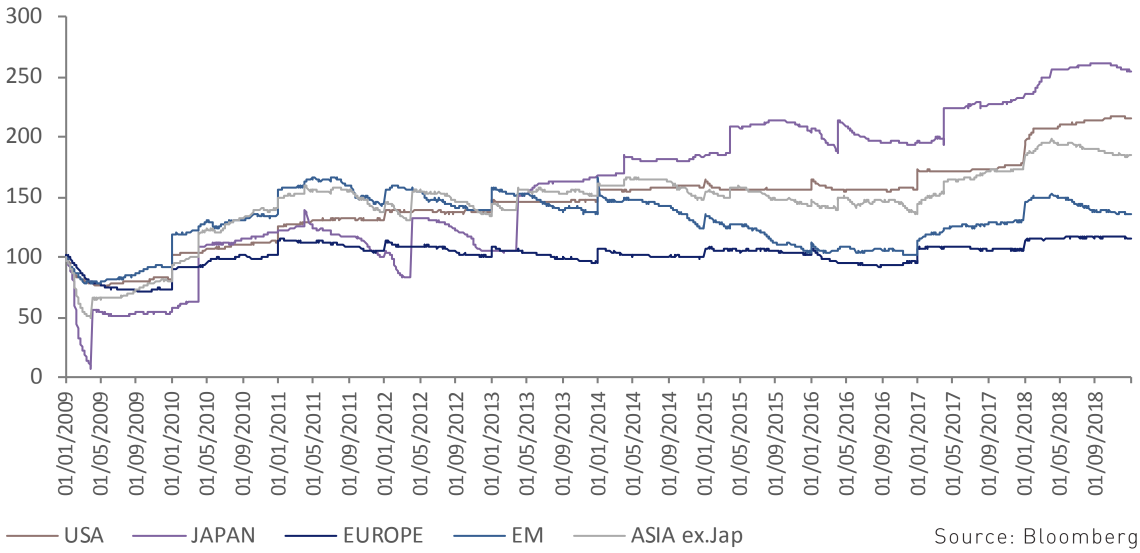
Clearly 2018 was not a year for stocks and shares and following a really quite substantial correction across most indices and regions, the question now is where pockets of value and opportunity have opened up and where there is further to fall. Having been underexposed to US stocks for some years now on the basis of stretched valuations (especially in the tech sector that we have written about in the past), we do feel slightly vindicated following the violent reversal in the American indices since the end of the summer. Up to this point US stocks had been in strong positive territory, while the rest of the world was in the red as growth faltered, the Dollar strengthened and a series of idiosyncratic emerging market events and political risk hurt sentiment. Donald Trump was winning the trade war with China as the US economy continued to fire on all cylinders: with record employment, strong earnings and high growth reflected in US equities – but then a cocktail of negative issues (US-China trade conflict, Italy/EU, Brexit, partial yield-curve inversion, slower growth) seen in the context of higher rates and late cycle, finally became overpowering enough to end the 'buy on dips' approach that investors have come to rely on since 2008. Valuations in the US remain high, though have clearly fallen back over recent months, and following the correction we are more comfortable holding American stocks than we were going into 2018, but still prefer a defensive stance meaning large-cap companies and avoiding the most highly-priced elements of the market. Economic data in the US remains strong and at historically high levels, and though recent PMI and GDP readings suggest the growth trend may be starting to slow, it remains ahead of other developed nations at this time. For investors whose base currency is not Dollars, having a little US equity exposure makes sense. Amazon is an interesting bellwether stock, and worth keeping an eye on for a number of reasons: it is a prominent growth stock, while it is both a 'tech' company and also a retailer that is exposed to consumption, and widely held in investment portfolios as a 'disruptor' that has the scale to affect any new industry. As such, it was notable that it was not immune to the recent turmoil, and we will be watching it carefully as an indicator of sentiment over the coming year. Likewise Apple was very recently punished by the market for missing revenue target by 4.8%, falling 10% in a day – symptomatic of how heavily even Wall Street royalty can suffer in the current climate. Also keenly watched will be the IPO of Uber, another disruptor and tech darling – will it list with an eye-watering initial valuation, or will market fatigue and the threat of more agile competitors see less enthusiasm for the launch? Overall we believe a focus on companies with strong balance sheets and earnings outlooks should be a safer approach late in the cycle, while buybacks remain supportive for US stocks for the time being as corporations use the savings from the tax cuts. We cannot ignore the fact that earnings expectations remain elevated, even after the recent correction, so we retain an underweight stance on global equities as the risk of disappointment and thus a further move down is asymmetric from this point.

Amazon Shares in 2018



Even companies as strong as Amazon were not immune to the correction at the end of 2018. Source: Bloomberg

Earnings Estimates

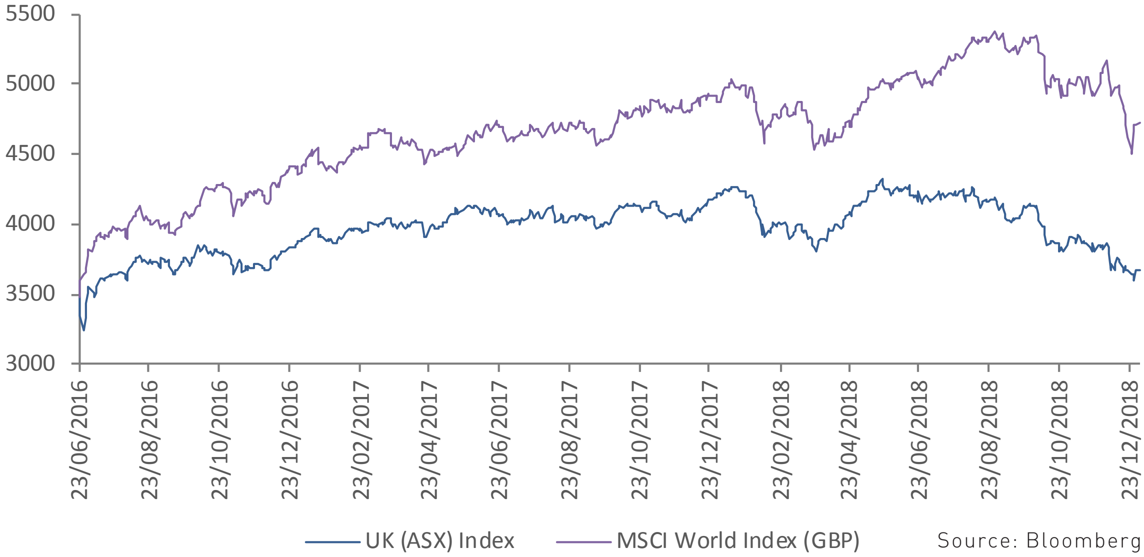


Source: Bloomberg

Earnings estimates remain elevated,though have started to plateau as the business cycle matures.

European equities did not enjoy the benefit of a positive first half of the year that US stocks did as they spent most of the year facing greater political risk, with the exporter-dominated indices particularly vulnerable to the US-China trade stand-off and prospect of a Chinese growth slowdown. It is difficult to envisage a catalyst for a significant move up for continental equities while earnings growth remain muted and the political scene continues to muddy the outlook, indeed GDP growth slipped in 2018 and PMI readings seem to have peaked in January of last year since the last high in 2011. The cyclical nature of many of the Eurozone's largest companies (miners, autos, banks) are acutely exposed to a global growth slowdown, and we remain of the view that these types of companies are in general best avoided for now, a view that seems justified as it has been the cyclical names that have suffered most throughout the recent bouts of selling. While growth may slow, especially export-driven growth, domestic consumption looks more positive supported by improving employment figures and wage growth and without any meaningful indication of inflation picking up, which suggests to us that logically companies that face the domestic consumer should do relatively well. On a valuation basis, the Stoxx 600 Index is well below its average 10yr PE of 20 at around 12x, while the dividend yield of nearly 4% is also now more appealing. European Parliament elections are to be held in May, however, and this is something of a risk event as the likelihood of anti-EU representatives gaining a stronger foothold in parliament is high, with so-called populist sentiment riding high across the continent as demonstrated by the row between Italy and the EU over its budget and the 'yellow-vest' protests in France. A surge in the number

British stocks have underperformed since the 2016 Referendum



Once the Brexit uncertainty clears, UK stocks look relatively attractive now.

of votes for non-establishment parties could well spook the markets and again bring into question the viability of the single currency, with the bloc forced to consider reform or further integration. As the UK is set to leave the EU at the end of March, and the terms of this departure still very much to be confirmed, there is considerable risk that equities will be in for a period of instability over the next few months. UK equities for their part, have been much unloved for some time and are now very attractively priced at 11X fwd PE with a yield of just below 5%, and we believe that providing some clarity one way or another is forthcoming at the end of March then British stocks could be set for a significant rebound. Whether there is clarity, of course, is by no means certain and if the negotiation period is extended then stocks could well linger in the doldrums until the uncertainty that markets hate dissipates.

Asia has been a favoured region of ours for a couple of years, and while in 2017 we enjoyed the outperformance of the region against most other markets, both emerging Asian and Japanese stocks retreated significantly in 2018 as Chinese growth slipped with several economies directly affected by the stand-off over trade with the US, while Japan's export economy saw the TOPIX indirectly affected for the same reasons, as well as by a sharp economic contraction and drop in capital expenditure in in Q3. However, we continue to maintain exposure to Asia for the long term potential for growth on offer in the region, accepting that this can be a bumpy ride at times. Part of the reason for the Japanese decline in 2018 was due to the strongest typhoon in 25 years as well as an earthquake, and there are causes for optimism with respect to domestic consumption (wages are climbing by 2.6% year on year, the unemployment rate is low), while the implementation of temporary visas for the sectors most in need of extra manpower should pave the way for growth. Furthermore, the once non-existent dividend yield of the Topix is now higher than the S&P500 at 2.4% and the forward valuation of 11.7X makes it an attractive market, relatively speaking. We also like the diversification benefits of holding assets in Japanese Yen, a currency that tends to hold its value well in times of stress as was seen in December. That growth in China is slowing is not a new realization, as the rate has been shrinking since 2010 (and recently the government has been squeezing the shadow credit markets as well), but it has very much steadied (at around 6.5% according the Chinese National Bureau of Statistics, nearer 4.5% to some outside observers), which is still a high rate compared with developed markets, and the transition to consumption theme is now in full swing. Providing the consumption picture stays strong, China looks cheap at 9X fwd PE following the 25% drop in the Shanghai Composite Index last year. India's stock market was one of the few bright spots in 2018, and we continue to favour some exposure here, though as ever we are aware of high valuations and internal politics, i.e. the ongoing tension between Narendra Modi and the central bank. Inflation risks seem to be dropping, helped by the lower oil price and it is likely that a rate cut may follow, which may boost equities and GDP is still over 7% with vast scope for more growth as the country should continue to benefit from the reforms and infrastructure spending of recent years. Emerging markets in general are at their cheapest point in over five years after the sell-off in 2018, and a selective approach to certain EM economies is bound to be a successful long term bet, while accepting that equities here will be buffeted by the struggles of developed markets. Even if some of the headwinds of 2019 recur, investors should be able to take some comfort from the already low valuations and the fact that emerging markets account for 40% of the world's growth though only 12% of the global stock market value.

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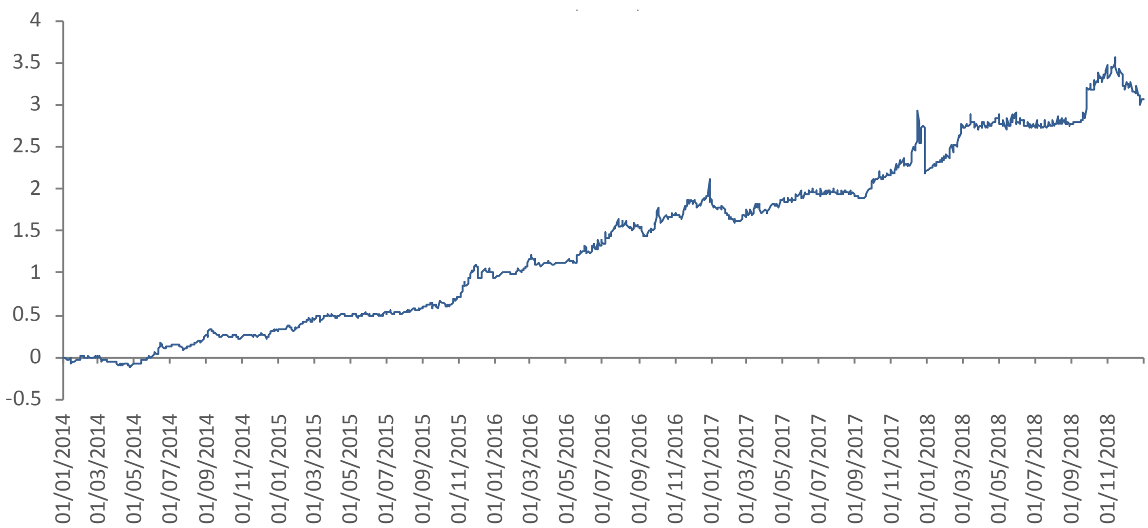
EQUITIES								**Tightening monetary policy, slowing growth and late cycle fears prevent us from being more optimistic on global equities.**
US								Fundamentals remain decent, but stretched valuations and heightened earnings expectations in some sections of the market mean it is susceptible to correction.
UK								UK assets have been left behind since the EU referendum, but are now attractively priced for a rebound if and when Brexit uncertainty clears. High dividends.
European								Slowing growth and a raft of poor data late in 2018, together with political risk lead us to an underweight position. We have a value bias.
Switzerland								A poor earnings season in Q3 and valuations have re-rated to more attractive levels. We like the defensive, stable nature of the Swiss market.
EM								Following a torrid 2018, China looks cheap, and we like emerging Asia. Net oil importing nations could enjoy a boost from lower crude price.
Japan								Very attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Growth should rebound.

Fixed Income

Despite 2018 being the worst year for returns on investment-grade debt since the financial crisis, there is little reason to expect significant returns from the asset class over the coming year - rather bonds should be regarded more as a store of value. The prospects of the asset class will much depend on the Federal Reserve in 2019, or rather on the expectations of the market versus the actual number of rate movements that transpire. In December these expectations changed dramatically as the market moved from pricing in two more rate rises in 2019 (which had been the case for most of 2018) to none at all. With the FOMC Members projections, or 'dot plots' still forecasting two rate rises – clearly something has to give! The main reason for this change in market sentiment was caused by a perceived softening in tone by Jerome Powell in the midst of December's equity market turmoil, specifically that he would be more accommodative to stock-market considerations and not just the real economy. On balance we feel the greater risk from here is the market is caught out by a more hawkish Fed, which together with the need to fund the fiscal deficit and upcoming infrastructure spending (in terms of new issuance) points to lower US Treasury prices and higher spreads for IG bonds. However, this readjustment is probably due to take place over time so the US 10yr yield of 3% is unlikely to be breached imminently and could settle at around 2.8% underpinning fixed income prices for now. With the 2yr Treasury yield now higher than the 5yr at around 2.5%, short dated treasuries look attractive for USD investors, but for non-USD investors options are more limited with short-dated EU treasuries still yielding negatively and UK Gilts less than 1% - and at the same time buying USD debt does not make sense for EUR investors because along with the obvious currency risk the hedging cost is now over 3%:



Source: Bloomberg

The cost of hedging dollars for EUR investors has risen from zero to over 3%, making it impossible to take advantage of higher USD rates.

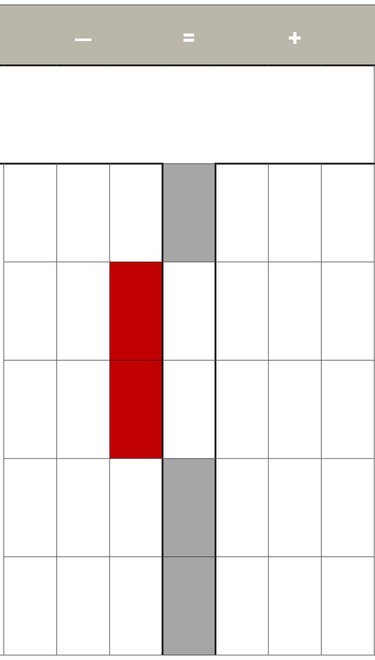
Sovereign European debt is unlikely to appear more attractive until the second half of the year, once we have hopefully passed the major hurdles of EU elections, Brexit and the Italian/EU budget row, and as already mentioned, yields are not appealing in any case and the ECB is aiming to end its asset-purchasing programme which ultimately means the largest buyer withdrawing from the market. Assuming the UK leaves the EU in March, there is scope for a rate rise by the BOE as it aims to continue normalising its monetary policy though this is likely to be inflation dependent and the effects of Brexit on this are unclear at the moment – in any case it is unwise to be holding too much long-dated, long duration UK debt until the picture is clearer. With respect to corporate debt, our suspicion is that with rates rising globally and the cost of refinancing therefore increasing it may be that the credit cycle is maturing and we could start to see more credit events at the lower end of the quality scale – and we note that over half of all investment-grade bonds now sit in the BBB category. Higher rates should result in less issuance, however, which should provide support to the quality names in the IG universe. The dual purpose of bonds (at least in a multi-asset portfolio) is to preserve capital, but also to provide some yield, so for European investors where local debt yields are currently non-existent and US debt is not viable, it is necessary to look further afield for income. As such we carry over our preference for Emerging Market debt into 2019, but of course in a very discriminate way with a focus on quality and bias to short duration. Emerging market bonds can react very severely to higher interest rates in the US, and with yields of around 4-5% available for very low duration (i.e. low sensitivity to rates) bonds, this is an attractive, relatively steady sweet spot for income seekers. Due to the mixed prospects we envisage for the Dollar, a split blend of local and hard currency (hedged for non-USD investors) emerging market bonds is the most suitable strategy, while being mindful of any further escalation of global trade conflicts.

Two Year Bond Yields EMEA

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	12/05/2019	-0.87
NETHERLANDS	12/03/2019	-0.69
GERMANY	15/09/2018	-0.60
DENMARK	14/06/2019	-0.60
AUSTRIA	15/11/2018	-0.60
BELGIUM	15/07/2019	-0.55
FINLAND	15/03/2019	-0.55
IRELAND	28/11/2018	-0.48
FRANCE	28/09/2019	-0.48
SWEDEN	25/02/2020	-0.42
PORTUGAL	18/06/2019	-0.28
SPAIN	06/02/2019	-0.21
JAPAN	30/04/2019	-0.18

COUNTRY	MATURITY	YIELD + / -
ITALY	11/04/2019	0.52
BRITAIN	22/01/2019	0.71
ISRAEL	15/04/2019	0.81
HONG KONG	30/03/2019	1.57
NEW ZEALAND	14/06/2019	1.68
AUSTRALIA	10/07/2018	1.81
CANADA	25/06/2019	1.84
SINGAPORE	31/05/2019	1.87
UNITED STATES	22/07/2019	2.48
ICELAND	25/07/2019	5.12

Source: Bloomberg

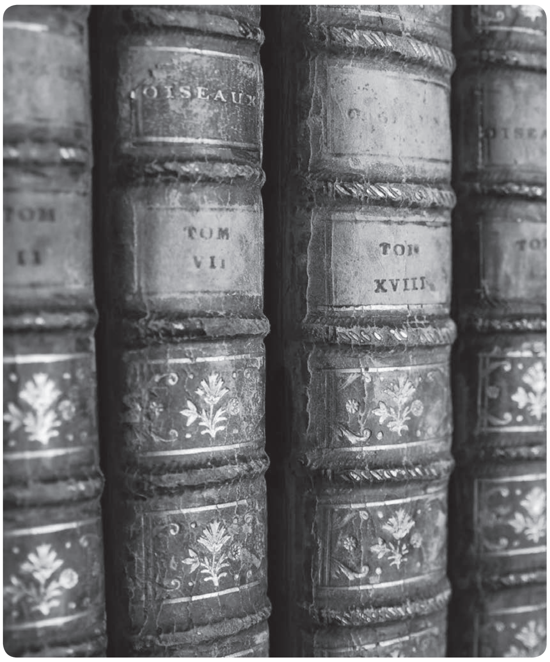


CURRENCY	USD looks strong short term, due to US economy and rate differential. The debt pile caps too much upside - expect some dollar weakening in 2019.
U.S. Dollar (DXY)	Fed's rate rises on course, though market vol could interrupt this, and possibly priced in. US Ecomomic growth is relatively strong and enjoys reserve currency support.
Sterling (GBP)	Prudent to take GBP risk off prior to Brexit clarity. Though rate agenda is more advanced than mainland EU. Long term likely to recover.
Euro (EUR)	Eurozone growth has slowed, and monetary policy is loose. ECB tapering will be slow. Expect medium-term weakness as political risk exists.
Japanese Yen (JPY)	Ranging near 110. In line with 30yr average price. Safe haven status is balanced by low rates and recently confirmed continued loose policy. Diversifier.
Swiss Franc (CHF)	CHF is staying close to parity with USD, but strengthening v EUR. Prefer to EUR. Negative rates and potential SNB action restrict upside.

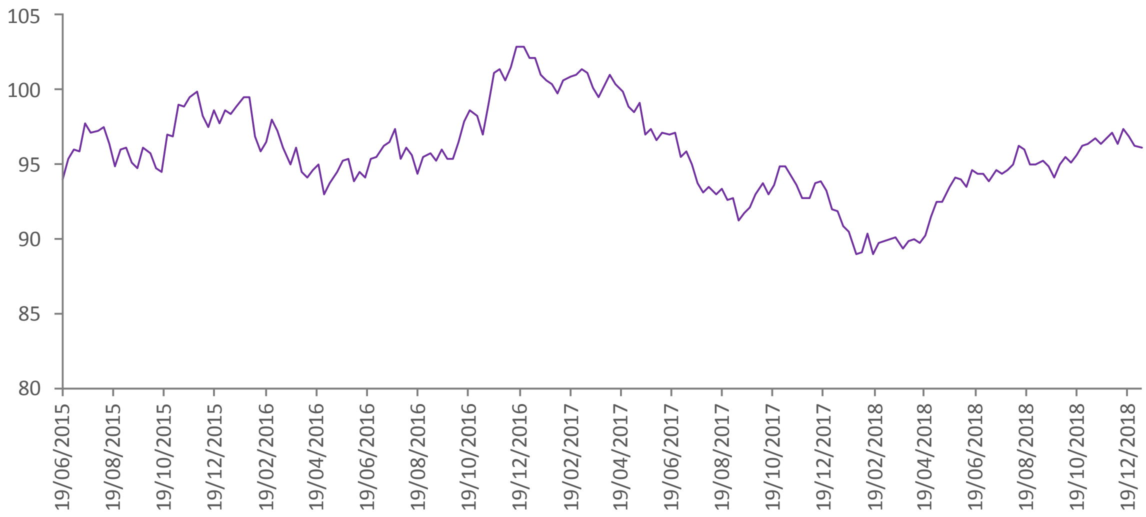
Commodities and Currencies

The direction and value of the US dollar is a vital to the prospects of many asset-allocation decisions, and in the near term we see support for the worlds reserve currency as political risk in Europe is elevated and while the economic growth story in the US remains ahead of other developed markets. With the FED target rate at 2.5% and the BOJ, ECB and SNB at 0% or lower, the interest rate differential is clear for all to see with only the UK's BOE offering a positive 0.75% - and due largely to Brexit, interest in GBP will not pick up until later in the year. If a seemingly smooth Brexit occurs we could even see the BOE proceed with maybe a couple of small hikes. As mentioned above, there are early signs that the rate of growth in the US is set to slow down as while employment, PMI numbers and GDP growth are strong, there has been some weakness in the autos, retail and housing numbers. The effect of tax cuts that provided such impetus for the economy since the Trump election are expected to fade towards the summer and should the market conclude that the current bout of rate hiking is set to end, it is difficult to see cause for an extra boost to the Dollar other than further bursts of global risk aversion. Moreover, inflation, despite high employment, has fallen away since June and if this continues the Fed is unlikely to add any extra hikes to support USD. There is still a risk that inflation could suddenly rise, catching the Fed out if they pause due to volatile markets, for example if we see a rise in commodity prices later in the year and especially if central banks do not continue to tighten as expected – or even reverse course and start printing. While we have no particularly strong conviction for most major currencies, emerging market currencies could well get a boost from a cooling of US/China trade tensions and a more dovish Federal Reserve.

Precious metals reacted exactly as we hoped they would in times of market stress, with gold climbing from two-year lows in August to close in on the $1300 mark towards the end of the year – justifying our belief that a balanced portfolio should always contain a minimum of 5% in gold as a hedging asset. For much of the year gold was suppressed by a strong dollar and fine economic growth prospects, but as the latter waivered and the stock markets fell, with the Fed's hiking plan looking less likely, investors once again looked to it as a real store of value. Silver, often seen as gold's poor relation, though actually having more commercial use, remains oversold versus gold on a technical basis with the gap between the two metals being as wide as it has ever



Dollar Index (DXY)



Source: Bloomberg

been – therefore a rise in the price of gold should see proportionally greater gains for silver from this point. Whether the current resurgence in precious metals continues will depend much on events in the stock and bond markets, but its recent behaviour is reassuring from a diversification perspective. Crude oil was keenly followed last year as it fell 40% from it's peak – largely because of oversupply as the US overtook Saudi Arabia as the largest producer of oil and because of increased fears of slowing global growth. OPEC and Russia have since pledged to step in and reduce production and in recent years this has been enough to halt the decline and already the price of Brent crude has moved off from the $50 a barrel level, and we envisage the price to range around this point for the foreseeable future as if it starts to move higher an irate US President will once again put pressure on OPEC to increase pumping.

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ALTERNATIVES								**Favour less correlated assets in light of overvalued stocks/bonds.**
Precious Metal								Fluctuating with risk sentiment - spot gold lower ytd. Important inflation hedge.
Hedge Funds								Long/Short and market neutral funds can protect downside in falling markets.
Oil/Commods								Supply has reduced, leading to rising Crude price. Expect oil to remain at current levels (Brent $55)

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Banque Havilland (Monaco) S.A.M. is also a member of a deposit guarantee scheme, the *Fonds de garantie des dépôts et de Résolution* (**FGDR**). Upon request, Banque Havilland (Monaco) S.A.M. can provide its clients with any further information on the deposit guarantee scheme. In addition, further information can be found on *www.garantiedesdepots.fr*.

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The availability of the services described in this brochure may be restricted by law. Further details are available upon request.

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