Banque Havilland
Compass
Fourth Quarter 2018

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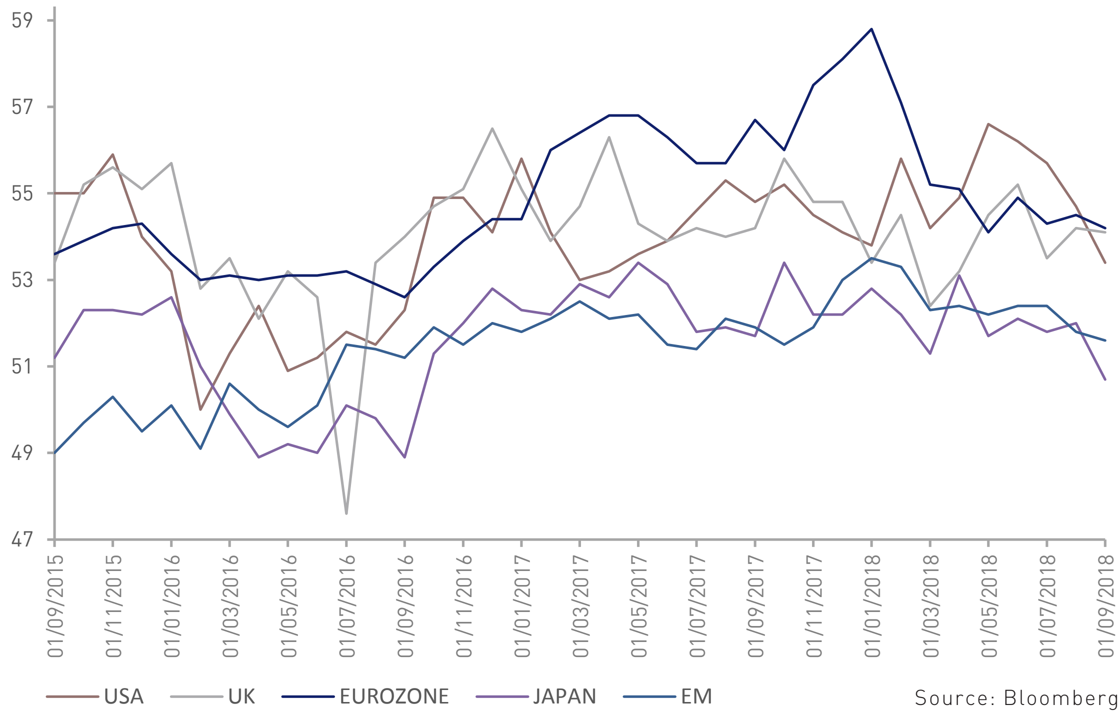
Market Environment

Much has been made of the 10 year anniversary of the great financial crisis that peaked in 2008 with the collapse of Lehman Brothers in September - and of course more significantly for those of us at Banque Havilland - a number of Icelandic banks later in October. It was also in October that the US government commenced its Troubled Asset Relief Programme (TARP) and global central banks including the Federal Reserve and Bank of England announced co-ordinated rate cuts that in turn led to Quantitative Easing in November, with the S&P500 marking its post-crisis low of 666 in March 2009. Ten years later and the same index is approaching 3000, while ostensibly the global economy is in a state of good health that few people would have envisaged possible back then: there was no great depression as many feared; employment now(outside the Eurozone) is at record levels in developed markets; growth (according to the Bank of International Settlements) is 'roughly on a par with pre-crisis levels'; and asset prices like equities, bonds and property have all enjoyed stellar returns. How much longer can this go on? This is the question that all investors are asking themselves, and has become more pertinent this year as the US is now 7 hikes into its attempts at rate normalisation, the UK raised its bank rate over the summer, and the ECB is aiming to finally exit its asset-purchasing by the end of the year. While we are indeed wary of tightening monetary policy in these three economies and the effect this will have on risk assets such as equities as well as on interest-bearing securities like bonds (and bearing in mind that consensus is that we are currently in the later stages of the business cycle), there are several mitigating factors that point to a continued favourable investment conditions. In the US, FED tightening is being countered by the late cycle stimulus of the Trump administration in the form of infrastructure spending and lower taxes, China seems to be initiating another bout of their own monetary easing to fend off fears of slowing growth, while Japan's not insignificant asset-purchasing activities have no near end in sight. While economic data shows that the rate of growth is slowing (especially in China), and indeed while it is unlikely that analysts in the US will again underestimate the tax-cuts effect on companies on the next set of earnings figures (i.e. expectations will be higher, so positive surprises for the market are less likely), there is still further scope for the economic global expansion to continue. As can be seen in the chart below, composite purchasing data remains in expansionist territory although has fallen from its peak seen earlier this year:

Composite PMI Readings



Source: Bloomberg

The US Yield curve is still flat compared with its historical average, though consensus is that risks of a recession are limited over the next year with many analysts suggesting 2020 may be the year one finally comes! In the short term, as ever, there are other challenges that markets and investors must overcome. Over the summer we saw emerging market equities enter a bear market (down over 20% from the peak in January) as a cocktail of factors coincided to damage sentiment in developing nations. Slowing Chinese growth has been exacerbated by the escalation in the trade tensions between the US and China, which has quickly moved from threats and rhetoric to being very real indeed, with the latest set of tariffs from the US affecting $200bn of Chinese goods. Whether this signals a new era of economic isolationism and US protectionism or a somewhat less chronic swift 'rebalancing' of the trading relationship (as the President sees it) is yet to be seen, but one thing that is clear is that China, and by proxy, other emerging markets are feeling the effects of this far more keenly than the US if asset prices are anything to go by. Even if the depreciation in the Renminbi softens the blow of the US import tariffs on the Chinese economy in the short term, and US growth eventually takes a hit as well – the markets are clear so far who is winning

US (S&P 500) vs China (Shanghai Comp.) ytd

Source: Bloomberg

this trade 'war'. While contagion from the effect of US tariffs have had a palpable knock-on effect on other emerging markets, as have more idiosyncratic situations at individual nations level: The crisis in Turkey is especially pronounced, due to the amount of debt held in foreign currency with government policies being starkly in contrast to investor's interests, as a politicised central bank fails to address inflation or the falling currency; Argentina has once again reached out with the begging bowl to the IMF as it finds itself unable to raise funds on the debt markets; while South Africa plunged into recession as a result of political and economic mismanagement that served to seriously harm the countries' crucial agricultural sector. All this against the backdrop of a strong US Dollar and the rising price of crude oil that has touched its' highest price since late 2014 – both these factors can act as a drag on growth for the global economy but have an enhanced effect on developing countries that are net importers of oil (see India) or hold large amounts of USD debt (Turkey). It seems that the contagion risk has been a little overcooked, and though the summer serves as a reminder that emerging markets do often move as one, there are sure to be more excellent buying opportunities when the dust settles, and it is likely that China will attempt to stem the slowing growth – though by which means is uncertain.

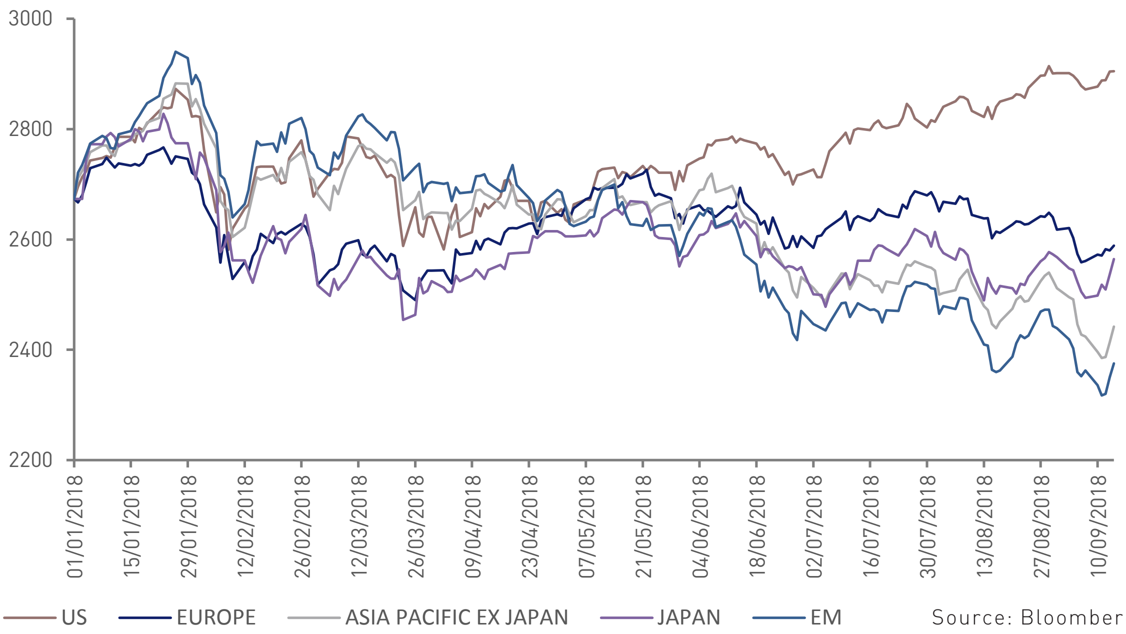
So while growth has softened globally, there is little in the hard data to indicate worrying times ahead – inflation remains more or less in 'goldilocks' territory, i.e. neither rising too fast or not at all, while employment is improving across developed economies and wages are starting to creep up. There is always a risk of a spike in prices should central banks misjudge the landscape and we retain some protection in our asset allocation for this scenario. Nevertheless 2018 has so far proved to be a challenging year for investors, especially for non-Dollar clients as USD strength and the stark dislocation between the American economy and the rest of the world has reflected asset prices. Exacerbating the divide between US equities and European equities has been the considerable noise around the Brexit negotiations as well as mounting fears that the Italian government is on course for an autumn collision with the EU regarding its budget proposals. Two years after the UK's vote to leave the EU, the fact that we are no closer to knowing the terms of the departure, is a frank reminder that political incompetence and mismanagement is not an exclusive feature of emerging market countries. A self-imposed deadline in October for the Brexit agreement threatens to coincide with the Italian's formal budget presentation which could mark a volatile period for European assets including the Euro. The Italian situation has the potential to rock fixed income markets, as has been seen by the spike in Italian government and bank bond yields, but quite how far the Populist coalition feels it can push the EU will depend on its perceived levels of public support at home, while in all likelihood some sort of compromise will be reached without addressing the underlying issue of Italy's unsustainable debt pile. Global debt, of course is very much the elephant in the room – in 2007 debt amounted to 179% of global GDP and in 2017 it had grown to 217% -so the risks that existed then have not entirely gone away, rather they are not so much held on the bank's and households' balance sheet but on those of governments and corporations. While debt levels remain so high, situations such as those in Italy, Turkey and Argentina will continue to assume more significance and attention than in previous eras as investors keep one eye on anything that could trigger a credit-related crisis, however, for now the focus is on squeezing out the last pockets of value from the ageing bull market while avoiding the most overpriced or exposed assets.

Equities

Stock markets remain dominated by the theme of divergence between the US and the rest of the world, and it is a theme that may well continue into next year and beyond. Macroeconomic readings have been consistently strong in the US, supported by decent corporate earnings, but it is likely that Fed rate rises and the accompanying tighter dollar liquidity are playing a significant part. The fiscal incentives offered to companies by the Trump administration are also undoubtedly supportive for US stocks, both in terms of the corporation rates and the encouragement to repatriate profits from overseas subsidiaries which has had the effect of sucking money back to the US (e.g. from emerging markets), with much of the extra cash not feeding through to the wider economy but resulting in stock buybacks and higher shareholders dividends. The dominance of the tech sector in leading the market gains has dwindled a little over the past quarter, which is reflected by the more muted performance of the Nasdaq index compared with the more industry-focussed Dow Jones in recent weeks – this is a welcome development as some of the more speculatively-valued tech stocks (Netflix, Facebook, Tesla, SNAP etc) adjust to more realistic levels, while the more solid, cash-generative businesses are better rewarded. As we have frequently pointed out, it would be irresponsible of us to be too heavily invested in stocks as the market cycle matures, though we are very conscious of the fact that a) it is impossible to know when the cycle will end, and b) often stocks enjoy good returns as they surge towards the end. With the observation of early signs that the tech-led boom is perhaps slowing, with more traditional industrials starting to close the gap it appears to signal that the 'type' of equity exposure held over the coming months and years could be crucial. While we remain cautious with respect to stocks in general for cyclical reasons as well as the high valuations, our preference now is for a gradual rotation into value-biased equities to complement our core market exposure.

For EURO-based investors, European equities will form the bedrock of their stock portfolios and the good news is that economic momentum is still relatively strong, (though this is unlikely to continue translating in to the sorts of gains enjoyed in recent years), and monetary policy remains favourable with no rate rises indicated by the ECB until September 2019. Forward earnings look steady without being wildly optimistic, though well behind the US and Japan, and the effect of both US trade policy and Brexit are dampening enthusiasm for the regions exporters. Again, we now marginally favour companies on the cheaper end of the valuation scale with a preference for more defensive names, having said that, even within value names we would prefer to hold off buying the very cheap European banking sector until the situation with Italys' budget and any knock-on effect to Italian banks is clearer.

Major MSCI Stock Indices ytd



Source: Bloomberg

Globally, we continue to look to Asia as the primary region for growth and therefore capital returns for our clients. Over the past five years, Japanese companies' average pre-tax profit margin has risen from 4.5% to 7.7%, which is well ahead of the of where it was during the good times of the late 1980's when valuations were far higher than they are now. The Japanese market remains relatively volatile compared with the US and Europe, but the positive outlook more than compensates for this at the moment in our view – GDP expanded at 1.9% in the second quarter of this year with growth expected to continue, driven largely by the automation, robotics and artificial intelligence sectors which are areas Japan has long been a leader in. Employment has been increasing steadily since 2009 while the government has started to relax restrictions on skilled immigration that bodes well for the economy in general. Furthermore dividends offered by Japanese stocks are improving, while the valuation of the TOPIX Index (forward PE) is just under 14, compared with 18 for the S&P500. Emerging Asia has been rocked over the summer and in recent weeks by the wider sentiment affecting developing markets, and aside from concerns over slowing Chinese growth, we feel this has been overdone with much of the risk contained to specific countries including Argentina, South Africa, Turkey and Brazil. India is a country we have liked for some time, but this year the rupee has fallen considerably versus the dollar as the higher oil price (India being net importer of crude) and this has translated into losses on the stock market as the Sensex has lost 12% from its peak in September. Indian stocks are not the most attractive in terms of valuation (though are currently re-rating), but the long term potential for growth is good – a young population and a rapidly increasing middle-class in lock-step with the effects of Prime Minister Narendra Modi's drastic reforms (which arguably have yet to be felt) should drive a consumption-led investment case in the coming years. How China deals with slowing growth though, is almost certain to be the dominant theme for emerging Asia in the coming months, and it is very difficult to forecast this with the unpredictable nature of US-China relations. The Chinese market has corrected over 23% since January, but at the same time so have valuations and it could be that at a forward PE of 11 much of the slowdown story has been priced in now.

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EQUITIES			■					**Equities look vulnerable. Global growth is sound, but slowing, while trade war concerns and Italian political risk are near-term concerns.**
US				■				Tax cuts boosting earnings. US indices are outperforming and highly valued, but strip out FANG names and the picture is less clear.
UK					■			Domestic stocks look cheap versus Europe/US, though we are aware of Brexit risk. Avoid FTSE 100, as exposed to global trade and GBP fluctuations.
European				■				Relatively attractive valuations, growth perhaps slowing now, still scope for returns. Supported by ECB loose policy. Avoid big exporters.
Switzerland					■			As Europe, but we like defensive nature and stable currency.
EM				■				MSCI EM is in a bear market on trade and China slowdown fears. We like Asia for long term consumption growth. Avoid politically unstable nations.
Japan					■			Growth dipped last quarter. Easy monetary policies remain. JPY offers diversification. Valuation remains relatively attractive.

Fixed Income

Our portfolios have become gradually more under-exposed to bonds over the course of 2018, and we are clearly not the only ones as all major fixed-income indices are registering losses this year, demonstrating the challenge of investing in markets where both major asset classes are generally over-valued. At the time of writing US 10 year Treasury yields (generally seen as a bell-weather for the fixed income market) have pushed above 3.2%, the highest since 2011, while the Global Aggregate Index is down over 3.3% this year alongside the Emerging market Index (down 3%) and Global Investment Grade (down over 4%). With shorter-dated EUR/German Sovereign Bonds still yielding negatively, the US Federal Reserve pressing on with rate rises in the face of a burgeoning economy, the aforementioned problems with emerging markets and Brexit concerns putting off international demand for British bonds – it is not difficult to see why fixed income markets are unloved at the moment. With record employment figures emanating from the US and UK for September and an oil price that has been rising since the start of 2016, inflation concerns are starting to reappear again having played second-fiddle to trade war concerns for most of the year since February's shock wage-data reading that spooked markets -while tariffs themselves, of course, also pose a risk for higher prices for consumers in the US and China. Adding to the negative sentiment towards the bond market are also basic supply and demand concerns. On the supply-side, corporate issuers especially will potentially rush to issue debt in anticipation of higher interest rates (and thus borrowing costs) in the future, while simultaneously some of the biggest buyers of bonds are reducing their activity i.e. central banks-the ECB is scheduled to finish its asset purchasing programme in December. In recent months the ECB has scaled back its purchases of corporate bonds, and this has pushed yields back up, with European Investment Grade bonds falling 1% since the middle of August, so the early evidence is that bonds affected by the ECB's activity could be in for a rough time as QE unwinds. The European bond market (both IG and high yield) is also unattractive while the current stand-off between Italy and the EU continues, with the bond market especially vulnerable to deterioration in relations. Italy's debt to GDP ratio at 130% is the highest of any nation that does not have its own currency, and with the EU committed to pushing Italy to reduce its' deficit and the Italian coalition government committed to its pre-election (higher) spending plans, any compromise will need to be very enterprising indeed. If confidence in Italian government debt is undermined further, this will quickly hurt already indebted Italian banks holding it on their balance sheet, which in turn could spread to other European banks holding Italian bank bonds. After October we will be in a better place to judge the merits of European bonds.

While US Treasuries will certainly start to look attractive to international investors if yields can remain higher than 3% and the Dollar remains strong, there is nevertheless considerable currency risk and increasingly high costs of hedging otherwise, and as such we continue to prefer a globally diversified basket of bonds. US high yield has been one area of strength this year, reflecting the US corporates that it is composed of, though we would be hesitant to add more at this point with rate rises set to continue, and it is essential to only look at the quality end of the high-yield universe to avoid the most indebted names. Likewise with emerging market debt – there are without doubt some attractively priced opportunities, especially following the weakness over the summer but special attention is required on the credit side, and we prefer short-dated, lower duration bonds which offer a decent yield of around 5% without some of the more extreme volatility of the longer-dated end of the market. In terms of currency we like a blend of USD and local EM bonds. With respect to duration in general, we have been tilting portfolios towards the lower end of the scale since the start of the year in the light of the Fed's clear rate-hike path, and anticipate that this will be the case for some time pending some unexpected change in direction.

Two Year Bond Yields

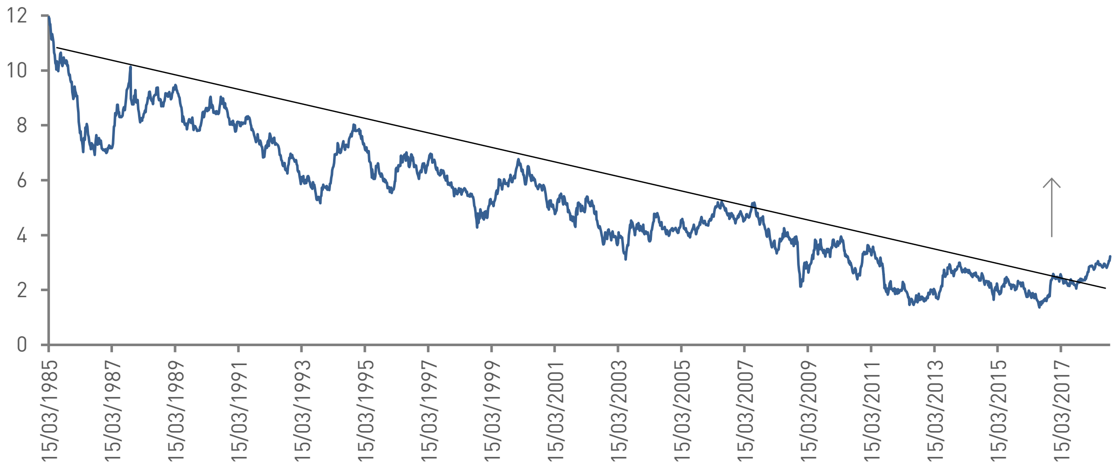
COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	06/07/2020	-0.78
NETHERLANDS	15/07/2020	-0.58
DENMARK	15/11/2020	-0.55
GERMANY	11/09/2020	-0.54
FINLAND	15/09/2020	-0.52
AUSTRIA	15/07/2020	-0.50
BELGIUM	28/09/2020	-0.48
SWEDEN	01/12/2020	-0.46
IRELAND	18/04/2020	-0.44
FRANCE	25/02/2021	-0.37
SPAIN	30/07/2020	-0.16
JAPAN	01/10/2020	-0.13
PORTUGAL	15/06/2020	-0.12

COUNTRY	MATURITY	YIELD + / -
ISRAEL	31/01/2020	0.25
BRITAIN	22/07/2020	0.88
ITALY	15/06/2020	1.42
NEW ZEALAND	15/04/2020	1.72
AUSTRALIA	21/11/2020	2.03
SINGAPORE	01/09/2020	2.05
HONG KONG	20/08/2020	2.13
CANADA	01/08/2020	2.30
UNITED STATES	30/09/2020	2.88
ICELAND	05/02/2020	5.16

Source: Bloomberg

US 10yr Treasury Yield, since 1985

... is this the end of the bond bull market?



Source: Bloomberg

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FIXED INCOME								**Yields are moving higher, despite stock volatility. Fed rate rises and unwinding QE are a headwind.**
Sovereign Bonds								Low yields remain unattractive, especially European. Worries about Italian bank contagion are now biting. US approaching attractive levels.
Investment Grade Bonds								Our core exposure to bonds. Credit risk is low, yields are unexciting but preferable to Sovereigns. Avoid currency risk. Diversified global approach best.
High Yield Bonds								Default rates are low and corporate US looks fine. We avoid European HY though.
E.M. Bonds								Selective buying opportunities following recent USD strength. Prefer short duration, BBB space.

Currencies

As mentioned earlier on, 2018 has been a year of US assets outperforming everything else and chief amongst these is the US Dollar itself with the Dollar Index up 4%, with only Japanese Yen holding its own so far. The strength of the world's reserve currency is unsurprising, considering the US is tightening monetary policy faster than anyone else; it has a stronger economy than most of its major competitors and US sovereign debt yields more than other developed market bonds. Also the repatriation of US companies foreign-based profits will undoubtedly have given the dollar a boost too while another reason for the surge in the Dollar Index from April to August may have been helped by US corporations rushing to complete their pension contributions before the deadline in September which saw the relief rate change to align with the corporation tax drop from 35% to 21%. Both these last two reasons are 'one-off' events that are likely to be matched by any other technical occurrence in the near future, so the dollar may have peaked for now at around 96 (DXY), unless US yields move so much that international money finds its way to the dollar via bond purchases. It is likely that dollar strength will persist in the short term while the European issues of Italian debt and Brexit pin back the Euro, though if these pass without too much drama in October and emerging markets find their footing once more, then we should see a declining green back in the longer term – all else remaining equal. Furthermore a basket of emerging currencies (JPM EM Ccy Index) is at its lowest point since the Index began in 2010 and according to some valuation metrics the cheapest they have been on a purchasing power parity basis for 20 years, suggesting there is plenty of scope for a significant rebound. Another consideration for believing the dollar upside is limited is a political one, with President Trump already making unimpressed noises with respect to the Fed's tightening fearing higher rates and a higher dollar undermines the US's competitiveness, while there is little doubt policy makers and the Whitehouse will not want rates too go too far bearing in mind the vast amount of total debt that needs servicing!

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CURRENCY								**USD looks strong short to medium term, due to US economy and FED. Longer term, the debt pile caps too much upside.**
U.S. Dollar (DXY)					■			Fed is on course to continue rate-hikes, while tax-cut inspired growth installs confidence in reserve ccy during uncertain times. DXY bobbing around 95.
Sterling (GBP)				■				Sold off heavily recently with USD strength/lower rate expectations. Steady vs Euro, as rate hikes likely to be slow due to Brexit uncertainty, and 'hard' Brexit likely priced in.
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)				■				Close to parity and ranging v USD, stronger v EUR. Seen ecent fear-based inflows - justifies holding some. Negative rates and dovish SNB restrict upside.

Commodities and Precious Metals

Alongside the years' notable theme of dollar gains, Crude oil has also been on a tear with Brent contracts up over 30% so far, though this has not been the case for the vast majority of other commodities. A number of factors have contributed to oils' rise, but in short it is a supply-side shortage that has driven the movement: while US Shale production itself has not slowed, the distribution pipeline for moving oil from the fields has effectively bottlenecked, while sanctions on Iran and a production collapse in Venezuela have meant supply falling behind demand. Venezuela three years ago used to produce nearly 2.4 million barrels a day, whereas this has now slid to just 1.3 million - a serious dent to the global supply. On the demand side global economic growth has been supportive, while Saudi Arabia and Russia remain committed to higher prices for now as OPEC cuts stay in place. We expect flat to higher oil prices in the medium term but expect the price to retreat a little once the Permian Basin distribution issues are resolved. Copper, which can be useful as a leading indicator is off 15% year to date though has recovered a little in Q3, and this can largely be attributed to the slowdown in China and the associated trade war – watch for such commodities to recover if there is a détente in China-US trade relations.

Precious metals, that form an important part of a multi-asset portfolio, have had a torrid 2018 with Gold and Silver down 9% and 15% respectively. It is never entirely clear what moves their price over the short term, but certainly the stronger dollar combined with fears over an inflation spike ebbing away over the course of the year will have seen Gold lose its shine, moreover, certain emerging market countries (e.g. Turkey, India) have been forced sellers of their reserves in order to fund supporting their ailing currencies. Technically Gold looks to have found a base around the $1200 level and if USD does indeed fall in the longer term or sentiment towards risk assets starts to sour we believe investors will look to precious metals again as a store of value - though often there is a lag between the risk event and the price of gold moving.

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