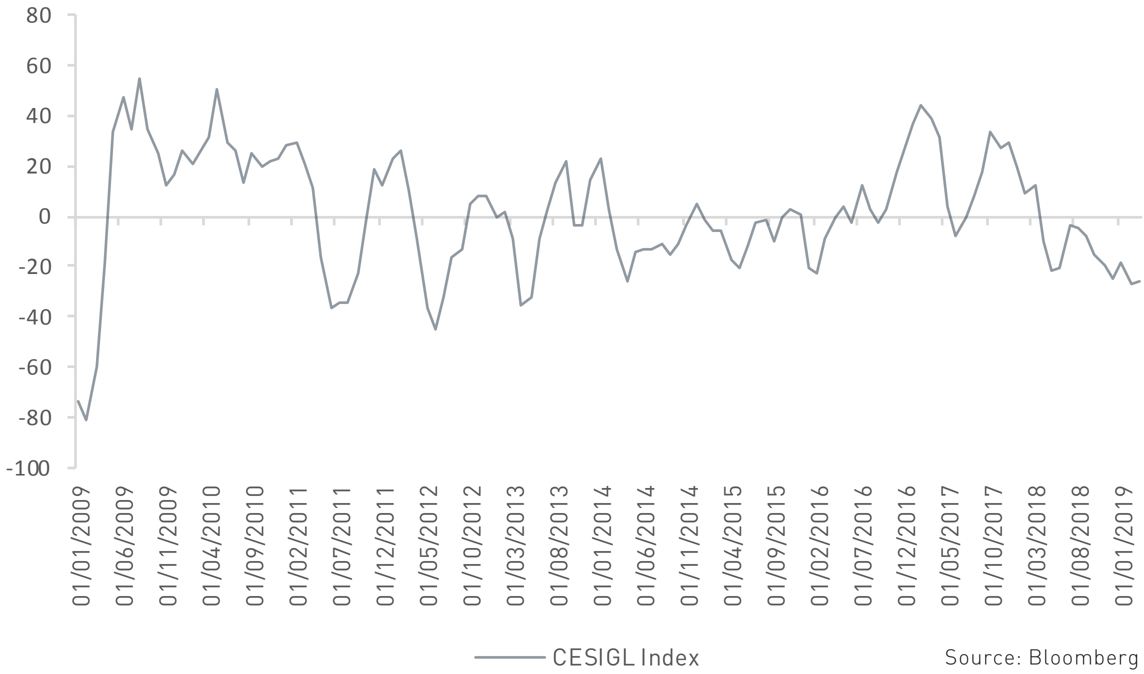
Banque Havilland
Compass
Second Quarter 2019

Contents

Market Environment

Asset performance in the first quarter of 2019 has seen an almost exact reversal of the last quarter of 2018, (excluding a few days at the end of December) that started the 'v-shaped' bounce in prices that markets have enjoyed year to date. Much was said about the Deutsche Bank report that concluded over 90% of investable assets made losses last year (in the worst year for investors since the Wall Street Crash of 1929), but three months later and stock indices are near the highs of 2018, benchmark bonds prices have retreated away from five-year lows, and commodities led by crude oil are up nearly 30% for the year. The party, it seems, is back on – but when will the music stop? And why is the music still playing? Traditionally, investors would look to a basket of major factors in assessing the outlook including economic growth, inflation, valuations, cyclical considerations and the geo-political backdrop – but now of course we need to add 'central bank policy' to this basket – and it is this factor that is perhaps the single-most dominant for markets at the moment. The Federal Reserve's December hike was almost certainly the catalyst, if not the reason, for the sell-off of that month and the subsequent rally has almost certainly been precipitated by the about-turn in Fed rhetoric since. All of these factors carry weight, however, and are more often than not inextricably linked. We examine these below, but for now, the Goldilocks scenario for equities (that of steady global growth, low inflation and easy monetary policy) remains in play, so we are invested accordingly while keeping a wary eye on a tense market environment.

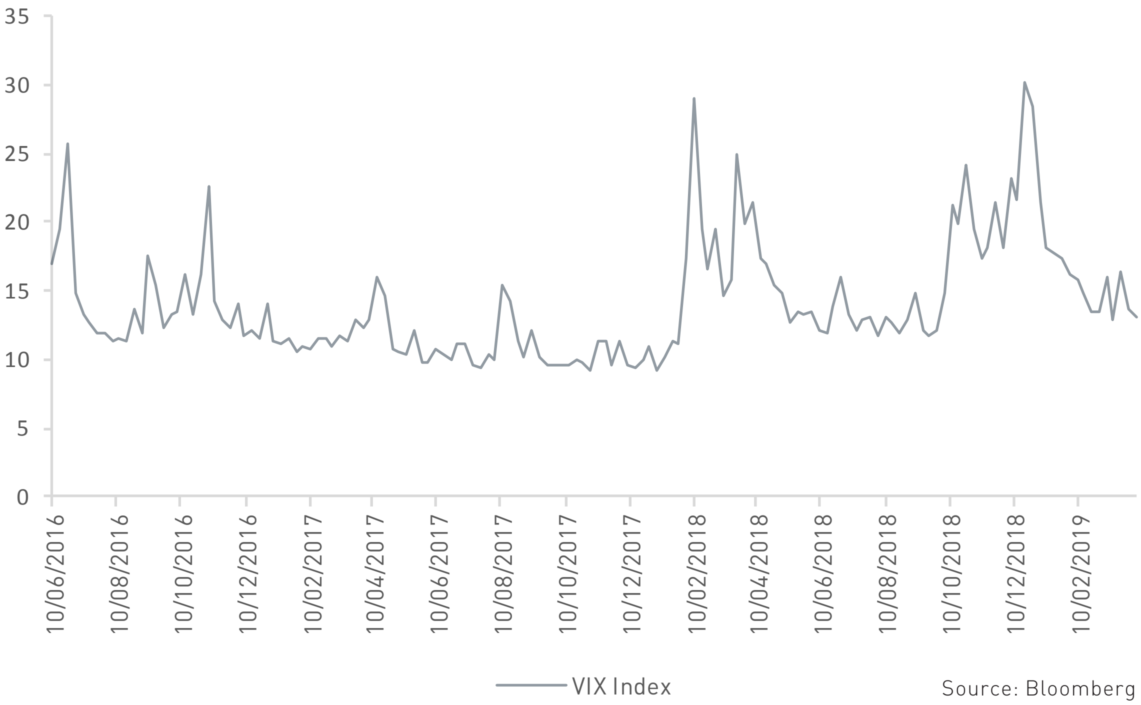
Citi Economic Surprise Index - Global



Source: Bloomberg

The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

Volatility Index



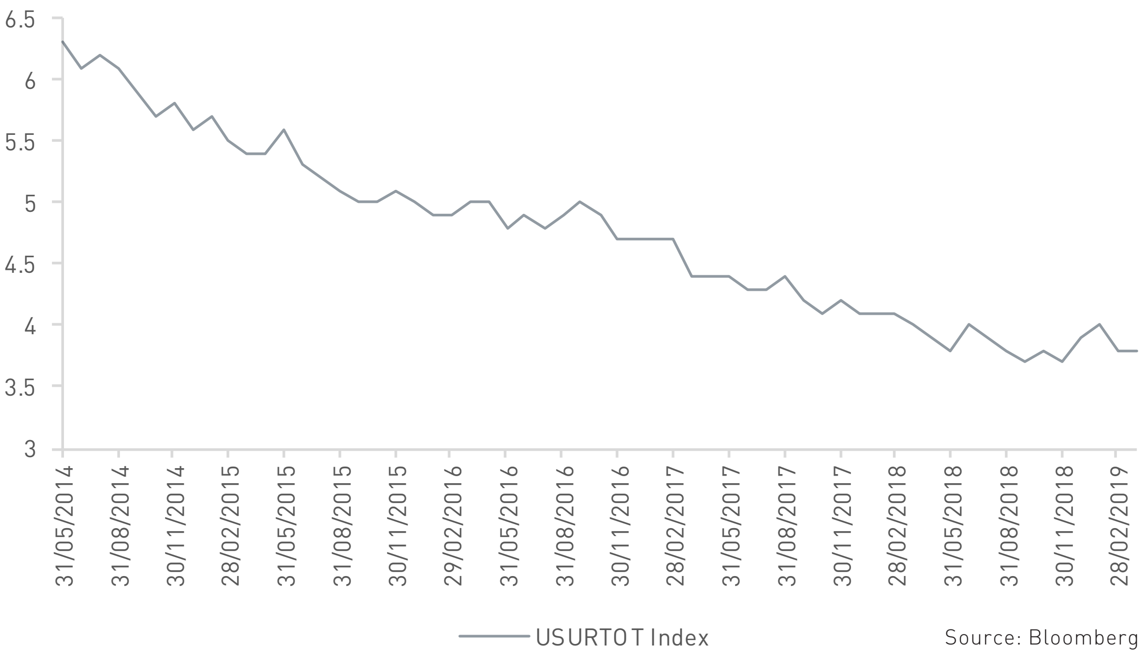
Source: Bloomberg

Volatility has dropped back to levels similar to last summer, prior to the correction.

Starting with growth, the global economy certainly seems to have cooled over the past year with PMI data in most countries dropping from mid 50's to low 50's and even below 50 for some of the larger Eurozone economies, and GDP rate-of-growth readings having been fading for some time. Naturally the main focus is on the US as the largest established economy and China, as the huge driver of growth in recent years. As is well known, the US has been on a tear, with GDP at its highest since 2015 fuelled further by fiscal stimulus since the Trump election and while the economy is still in expansion territory there are signs the peak level of growth has passed. While leading indicators have weakened they remain stable – suggesting that though the stellar market returns of the past few years are unlikely to be replicated in 2019 there is conversely no evidence of a growth headwind to hold stocks back. In China too, leading indicators are on the mend following a poor year for the regions equities that saw the CSI 300 Index slump by over 25%, and the government has also returned to stimulate the economy which bodes well for equities and earnings, including business tax and fee cuts as well as a VAT reduction. While we would not expect to see stimulus go too far bearing in mind the huge debt pile Beijing has to manage (Bloomberg estimates Total debt to GDP at 265%!), the sheer size of the economy means that at its current size 6% growth in China's economy adds the GDP equivalent of another Switzerland each year – meaning it is a market impossible for investors to ignore. Like the US we do not expect double digit % returns for the rest of the year, but the stimulus and modest credit loosening should at least put a floor under growth. In Europe, the picture is undeniably less rosy with GDP growth for the region back at 2017 levels and PMI Composite readings in decline for over a year led by Germany and Italy, with the former at the crux of a global manufacturing slump fuelled by trade uncertainty and weakening demand. Uncertainty over Brexit and fears that the US President could turn his focus from China to Germany's trade surplus with the USA are also no doubt playing their part in undermining confidence in the Eurozone's export-reliant economy (see Auto sales). The consumer consumption story in Europe does, however, give cause for some optimism and remains encouragingly robust and feeds our preference for taking stock exposure towards more domestic-facing (often mid-cap) companies, while employment figures continue to improve across the continent.

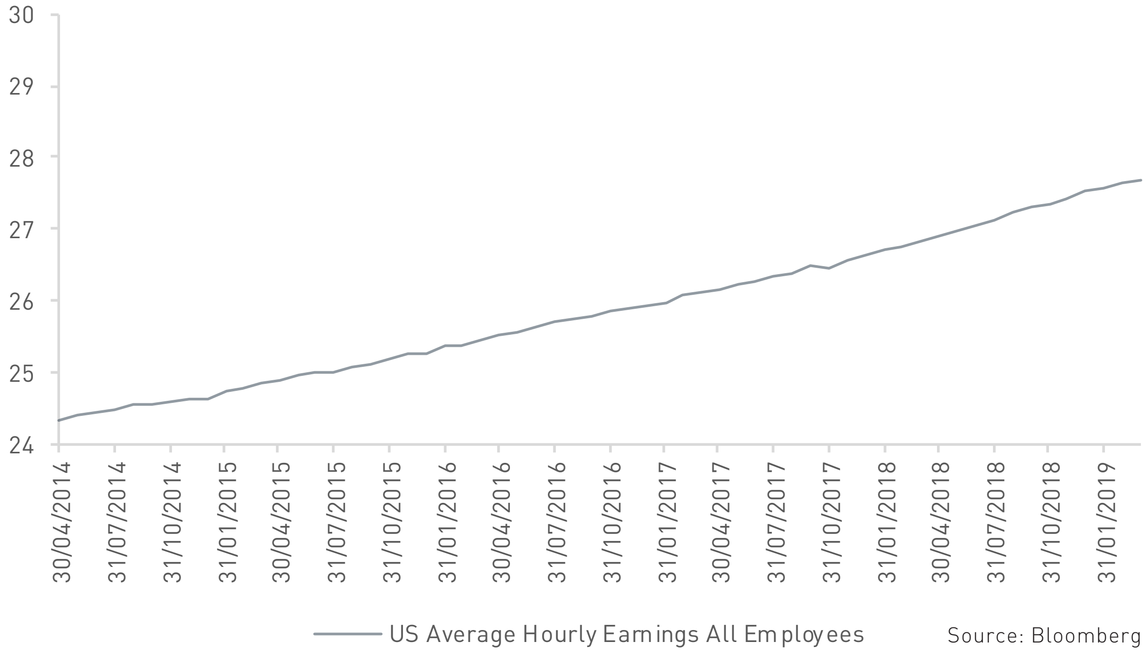
Indeed, high employment rates are currently something of a global phenomenon in developed countries, despite the constant noise of political uncertainty, fears of slowing growth and the increasing amount of rhetoric that robots will take more and more jobs away from workers. Even across economies with very different labour laws, employment seems to be strong, for example in the UK and US with relatively flexible labour/weak unions unemployment is 3.9% and 4% respectively (though the US labour participation rate has also been falling – meaning an overall smaller pool of workers so flattering the employment figures). In Canada where there are quite restrictive labour laws unemployment is at a 10 year low, likewise in France and even Germany where unions are strong and the economy is struggling. In Australia too, the economy is wobbling but unemployment has dipped below 5%. Though the extraordinary advances in automation and technology have taken the blame for 'destroying jobs' (e.g, in retail), the millions of jobs created and enabled by the increased connectivity and instant networking ability afforded by the internet have almost certainly been overlooked – particularly in the case of small businesses and highly-skilled free-lancers. On a net basis technology has almost certainly created more jobs than it has ended. Societal change in recent years alongside technology is also encouraging more women into the work place as well as the elderly, while an increasing acceptance of flexibility in working patterns is attracting workers not suited to the traditional 9-5 office or factory job. Unemployment data is not only important for an immediate gauge of economic and social health, it is also a key factor in the likelihood for inflation. Theoretically, inflation would be expected to rise along with high employment and higher wages (notwithstanding the declining participation rate), but despite both these being strong inflation is strangely muted and has been for some time. Several reasons for the continued suppression of inflation have been proposed: globalisation (i.e. the conveyor belt of cheap labour, imports and outsourced costs): technology/the internet again; a prolonged period of lower commodity prices since 2008: and of course, low interest rates. As none of these themes are particularly short-term in nature, (and rates both sides of the Atlantic are apparently not likely to be higher this year) and would be expected to continue, it is therefore unclear what could cause an increase in inflation to breakout in the immediate future.

US Unemployment



US Unemployment has dropped from over 6% to 3.8% in 5 years.

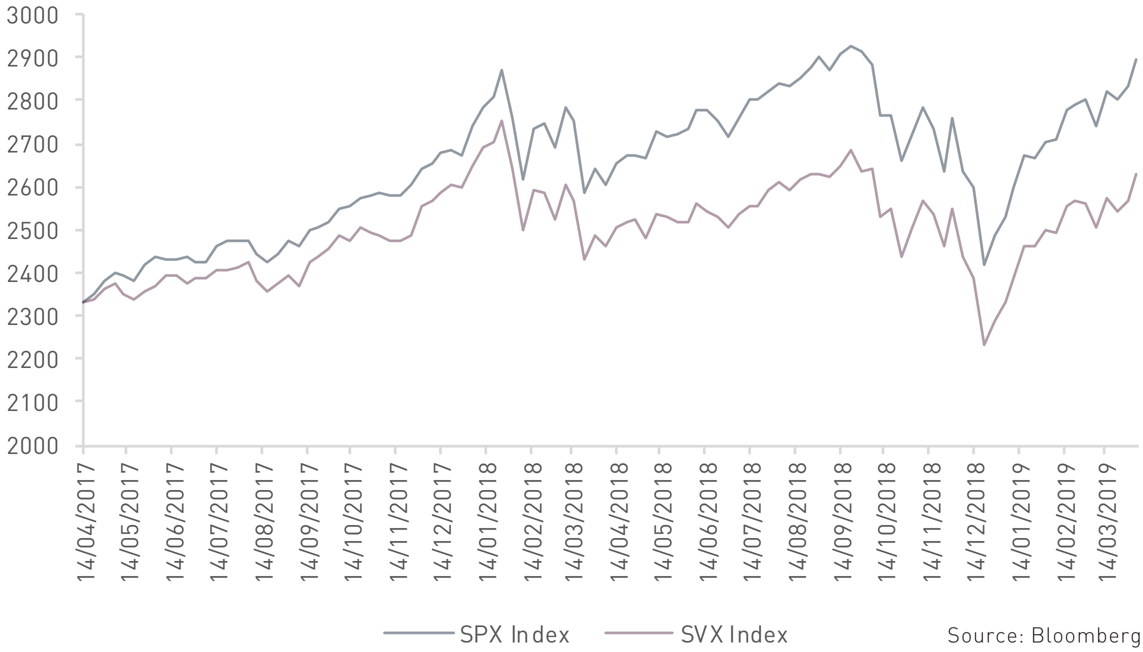
US Wages



Average US hourly wages continue to rise, alongside employment.

In 2018 we were concerned that valuations in the equity market were unhealthily stretched, and while this does not necessarily enkindle a correction in itself – it can mean that when a sell-off occurs as it did at the end of last year investors are already nervous and the scale of the market movement can be severe. Following just this scenario in December valuations did cheapen temporarily, though the speed of the stock market recovery has seen much of the losses recovered and therefore the opportunity to take advantage of the dip in valuations was very narrow indeed. Having said this valuations are generally still below the average multiples we have seen over the last three years on a P/E basis, which suggests that there is no immediate valuation resistance to higher stock prices, though this will become prescient once more should prices rise much further from here. It is important to be selective in such an environment, specifically by avoiding the most expensive parts of the market which following a rally in 'quality' suggests that value stocks from here would be the better risk-adjusted approach. There are also pockets of value to be found within a global allocation, for example in Japan that has recently seen some big earnings downgrades and macro/export headwinds, and the UK that has been relatively shunned by investors for the best part of three years due to Brexit uncertainty. The attraction of value, or at least defensive stocks is also intuitive in consideration of the economic cycle, of which are we are now certainly in the late stages of by any metric. This doesn't imply an imminent downturn by any means, and despite much fuss about the US yield curve inverting in late March, in reality this was quickly reversed following some strong PMI data from China and in any case only affected the front/middle of the curve and not the longer (20yr+) yields that would really be a strong signal. Even following a more 'genuine' inversion, the lag between the signal and any subsequent recession tends to be from one year onwards.

SPX and SVX Indexes



Over 2 years the spread between US Index and Value stocks has widened.

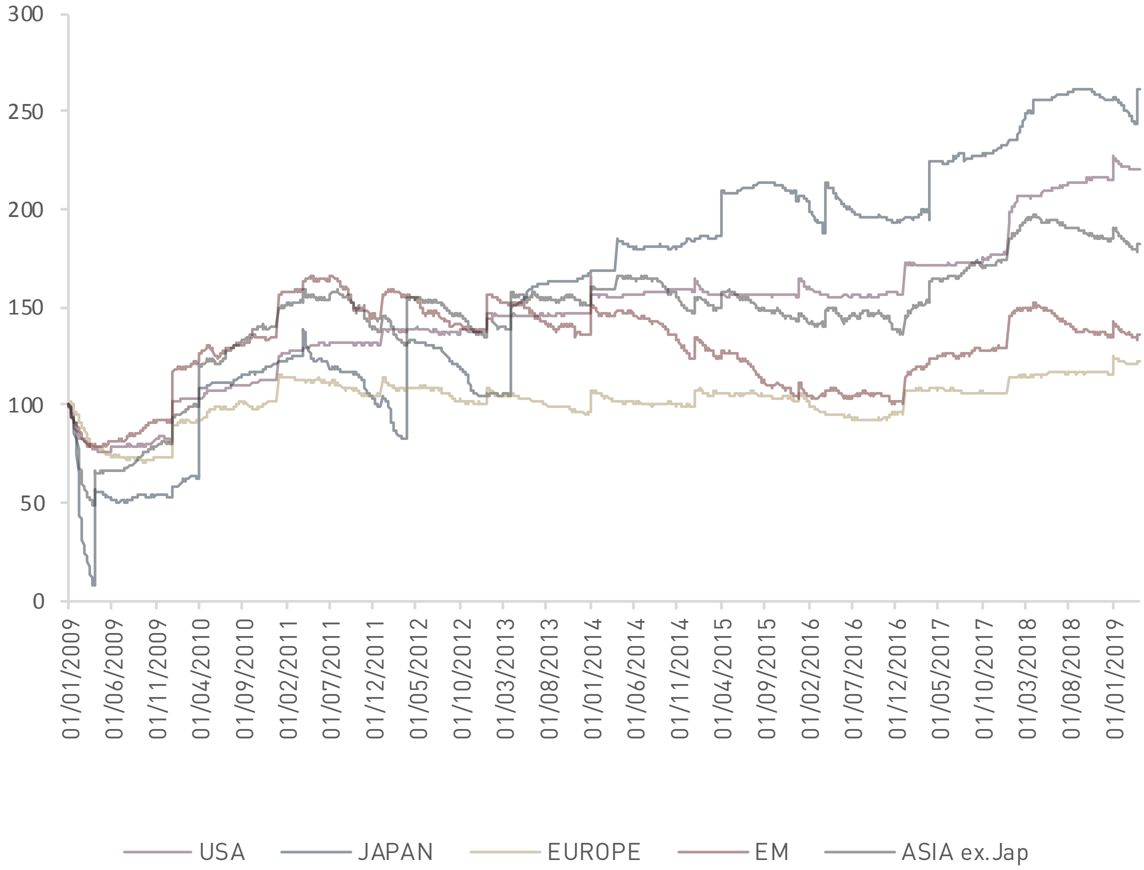
With respect to the geo-political scene, many of the clouds that were obscuring investors outlooks in Q1 have largely dispersed and this serves as a reminder that while political risk makes for interesting headlines and discussions, they can more often than not be discounted when making long-term investment decisions. The US/China trade tensions have dissipated somewhat (at least short-term), the US Government shut-down has been and gone and the unrest in various emerging markets has also moved from the front pages. Brexit of course remains unresolved, though the effective paralysis of the British government is arguably of far less concern to market participants than one may expect if recent examples of other nations' recent experiences are to go by: in 2016 the Spanish political system was deadlocked yet the economy grew 3.2%: the American shutdown was accompanied by a surge in stock prices; and the six-month period following the German election in 2017 coincided with expansion of 2.2% in that year! European Parliament elections potentially present a headache in the coming quarter should the predicted 'populist' increase come to pass, but it is hard to see why this should derail the markets - and while many of the above mentioned risks may be dormant as opposed to resolved (e.g. Italian spending budget) the short term risks to market sentiment from political risk seems subdued.

EQUITIES

With the overall environment for risk assets being broadly accommodative in the medium term, we are comfortable with a weighting in equities a little higher than in our allocation's recent history, though we still remain below the neutral level due to the risks of being over-invested late cycle and our view that earnings expectations are too optimistic. US profit margins are currently well above the highs of the previous cycle which is positive, but does leave corporates' bottom line prone should any mean reversion occur. Furthermore, market volatility has once again dropped to the levels seen prior to the 2018 Q4 correction which suggests we should be wary of complacency and after such a strong start to the year for equities it is hard to see what catalyst exists for further significant gains from this point into the rest of 2019. Earnings on the S&P500 may well have peaked in Q3 last year and though they did grow in Q4 it was at around 13% down from 24% in Q3, and with analysts generally expecting the fiscal stimulus in the form of corporate tax cuts to finally wear off by this summer, it is likely that any upside surprises will be limited. However, we have been caught out before by growth and earnings being better than expected and conversely such an eventuality could pose more of a risk to the market than benign growth, as it could prompt the Federal Reserve to flip its 'patient' stance once more and again spook the markets – in a sense good news fundamentally could be bad news for stocks. In Europe, investors can be confident that the ECB will not be raising rates this year following the particularly dovish March meeting which should put a line under European stocks, however weak economic momentum and the constant spectre of Brexit and other political risks prevents us from being more constructive on the region. Within our European allocation, we are looking to undervalued aspects of the market including a new exposure to small-cap stocks (which have fallen behind large-caps over the past year), and value-orientated positions in companies that have not necessarily been carried along by the recent wave. By design, this includes several UK names that are healthy, cash-generative businesses that have been held back by general Brexit-induced malaise affecting UK assets and we believe that even a no-deal scenario should not worry investors disproportionately. The Swiss market provides a defensive, yet quality aspect to our European basket and this has worked well so far for clients.

A resolution of the trade stand-off between China and the US will benefit many of the world's equity markets, and the news-flow at the time of writing suggests that this is probable – even if the overall relationship between the two countries will undoubtedly remain tense as the power-play perpetuates with corresponding periods of volatility to be expected. On balance, Asia continues to look attractive in terms of both developing markets such as India and China as well as Japan, which following a period of introspection looks ripe for an equity boost as GDP rebounded to 1.4% in the fourth quarter, and the third 'arrow' of Prime Minister Abe's reforms (improved corporate governance) set to take hold. Furthermore, Japanese valuations are very attractive on a relative basis with a forward P/E of 12.5x compared with nearly 16x globally, and a dividend yield now above that of the S&P 500. India, while not being so cheaply-valued stands to benefit from the re-election of Narendra Modi and his business-friendly agenda, and while GDP has slowed a little (still at 6.5%!) the country is alone contributing as much to world growth as the UK, France and Germany combined. The opportunities offered by the demographic shifts in India are well-known and a further dimension to this is growing evidence of increasing participation in the domestic stock market by the population, both in terms of interest in mutual funds and necessary flows from retirement funds. In short, our approach to equities is to have a cautious top-line allocation, but to take high conviction in the markets we feel are under-appreciated or offer serious growth potential in the longer term.

Earnings estimates



Source: Bloomberg

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

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EQUITIES								**Global growth is slowing, and valuations are not cheap but central bank accomodation should support equities in medium term.**
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.
Eurozone								Slowing growth and a raft of poor recent economic data, together with political risk lead us to an underweight position. We have a value bias.
Switzerland								A stellar start to the year following valuations re-rating to more attractive levels. We like the defensive, stable nature of the Swiss market.
EM								China has rebounded significantly ytd, as a number of factors remain supportive, despite slowing growth. Continue to favour Asia, with too much political risk elsewhere.
Japan								Very attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Growth should rebound.

Fixed Income

With interest rates set to stay lower for longer again and inflation still low, bonds have enjoyed a resurgence since November meaning multi-asset investors have enjoyed high returns in their portfolios as the traditional inverse correlation patterns expected between stocks and bonds melted away. It does not seem long ago we were questioning whether the multi-decade bull market for government debt was finally ending when US 10 year Treasuries were yielding 3.2%, but now with the yield back down at 2.5% it could appear that the trend that started in 1989 is about to resume. Most alarming of all was the sight of the German benchmark 10 year rate dropping (albeit briefly) into negative territory, such was the reaction to the ECB's latest reiteration of 'whatever it takes', as the hunt for yield for European bond investors once again became very difficult indeed. In particular the flattening of the 2yr to 10yr part of the curve has been pronounced, indicating problems for the Eurozone bond market. While recognising the role of Sovereign bonds as a short-term store of value, especially while stocks are once again elevated, it remains an unpalatable fact that any long term holding in the asset class will erode wealth, and as such our exposure to German sovereigns is limited and though peripheral debt such as Italy and Greece offer a bit of carry, the downside risks due to EU/ political developments are too prominent. With the ECB effectively putting a floor under the bond market for the rest of the year, however, we do see opportunities in mortgage-backed securities in the region with repossession rates low, credit ratings high and an attractive yield of over 4%. Ostensibly, the most unattractive part of the bond market is that of corporate investment grade (particularly in EUR and CHF terms) as yields are trailing that of inflation (which is low) but also do not benefit from the safe-haven flows that Government debt does – we are therefore wary of holding too large a weighting in IG debt.

Two Year Bond Yields EMEA

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	12/05/2019	-0.82
DENMARK	12/03/2019	-0.64
NETHERLANDS	15/09/2018	-0.60
GERMANY	14/06/2019	-0.59
FINLAND	15/11/2018	-0.56
AUSTRIA	15/07/2019	-0.54
FRANCE	15/03/2019	-0.52
SWEDEN	28/11/2018	-0.49
BELGIUM	28/09/2019	-0.49
SPAIN	25/02/2020	-0.35
PORTUGAL	18/06/2019	-0.33
JAPAN	06/02/2019	-0.17
ITALY	30/04/2019	0.28

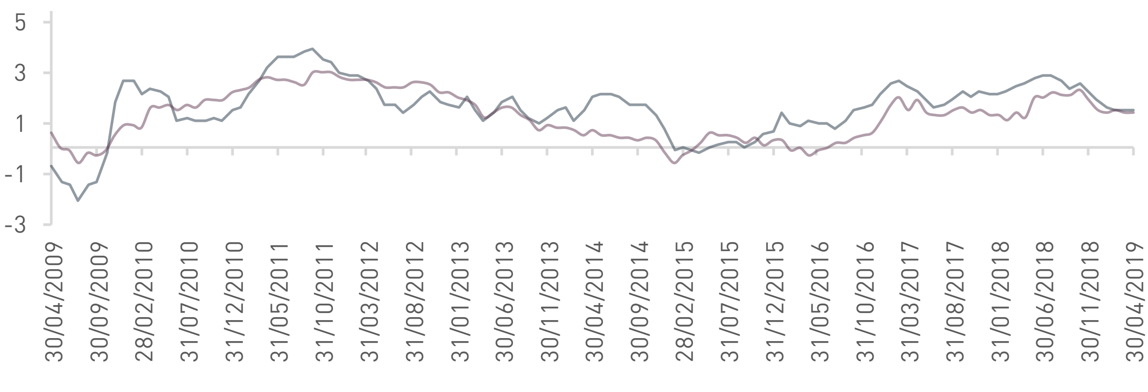
COUNTRY	MATURITY	YIELD + / -
ISRAEL	11/04/2019	0.52
BRITAIN	22/01/2019	0.70
HONG KONG	15/04/2019	1.41
NEW ZEALAND	30/03/2019	1.47
AUSTRALIA	14/06/2019	1.50
CANADA	10/07/2018	1.59
SINGAPORE	25/06/2019	1.85
UNITED STATES	31/05/2019	2.35
ICELAND	22/07/2019	4.18

Source: Bloomberg

	–			=		+		
FIXED INCOME								**Yields are low, as central bank support fades with higher rates a threat and US corporates face higher refinancing costs**
Sovereign Bonds								US 2yr attractive, but EUR and GBP investors outpriced by hedge costs. Only support will be from short-term safe haven purposes.
Corporate I.Grade Bonds								We prefer quality corporate to Sovereigns, but investors should adjust expectations accordingly in terms of yield with a focus on low-duration senior debt.
High Yield Bonds								We are less bullish on US HY than last year due to maturing credit cycle, but fundamentals look ok. Low default rates, but careful selection needed.
E.M. Bonds								Yields are still relatively preferable to developed markets, though we only choose to take low-duration, quality exposure.

Elsewhere, we believe emerging market debt to offer some attractive carry when carefully selected and our view of a stable-to-lower US Dollar supports a holding in both hard and local currency and the FED dovishness together with Chinese stimulus should also provide a tailwind – as ever credit selection and liquidity considerations here are essential. With the US economy chugging along high-yield debt remains attractive as the threat of defaults is suppressed, though with the total return of the Global index up 7% in just one quarter it is prudent to question quite how much further this can run in the short term, but at least the threat of leveraged US companies struggling to roll over their debts as rates move higher has fallen away for now. It is fair to say that the market is possibly more concerned by deflation at the moment than any sudden spike in inflation - a further support for bonds – and core inflation (ex-energy) has been sliding since June last year in both the US and Europe. With political risk apparently subsiding and the oil and copper prices having recovered from last years slump, we continue to see the near-term future for inflation as benign, though retain an exposure to some real-return linked bonds to mitigate an unforeseen rise. We retain a broadly neutral-low duration stance for bonds within the context of a multi-asset strategy because interest rates are seemingly on hold for the year ahead, with the futures market seeing a cut more likely than a hike by the end of 2019. However, we note the Federal Reserve left room in their outlook for one more raise if necessary, and this is not as unlikely as many assume should there be an uptick in US economic data in the second half.

CPI



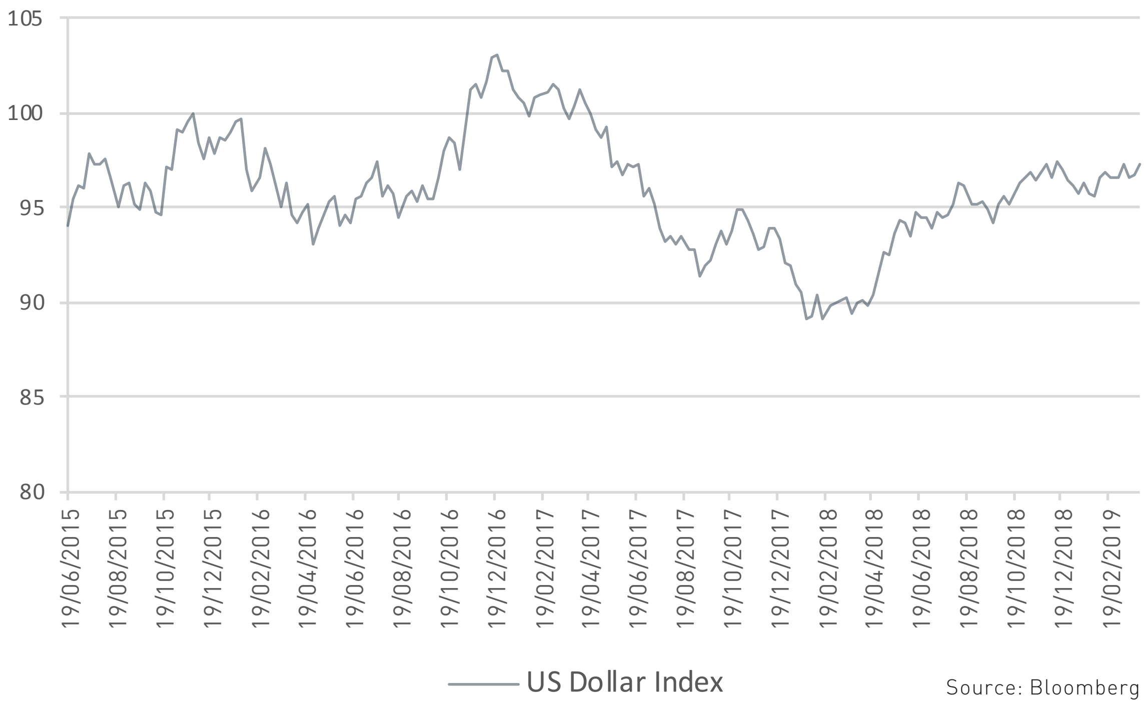
Source: Bloomberg

Inflation has not risen alongside asset prices since 2009.

Commodities and Currencies

In the last quarter outlook we expressed the view that the US Dollar looked well-supported in the near term, but expected it to drop off in the second half of the year, and this scenario still looks most accurate at the moment as further rate-support for the dollar has all but faded. Data released by the International Monetary Fund last week showed that the US dollar's share of central bank currency reserves fell in the fourth quarter of 2018 to 61.94pc of the total and this was the third-consecutive quarter of falls suggesting that USD faces some long term resistance as Russia and China look to reduce their reliance on dollars. Nevertheless, currencies are a relative consideration and certainly versus the Euro we would prefer USD: while the USA's debt pile continues to rise it remains for now the world's reserve currency and the Eurozone has more political and structural uncertainty that will weigh the Euro down, not to mention an ailing economic scene in it's powerhouse Germany, where a string of woeful factory orders suggest serious contraction. Technically the Euro looks in a state of steady decline versus the dollar since March 2018 and the ECB has postponed any monetary tightening indefinitely. The Dollar has been strong against most major currencies ytd, with Pounds being the exception, rising from a base of low expectation as the market starts to price in a 'soft' Brexit while UK data has remained remarkably resilient throughout the uncertainty. An abrupt, WTO/hard/no-deal Brexit would certainly see an immediate sell-off in Sterling but this would be tempered by the Bank of England's response and would itself cushion against the higher import costs of EU tariffs and Sterling would probably stabilise quicker than imagined. We would not advocate a speculative GBP position until there is more clarity over Brexit. Japanese Yen has potential to strengthen versus USD as a cheap defensive alternative and has been steadily doing so for a year while Swiss stability may offer upside for the Franc though will likely oscillate around parity. Emerging market currencies are probably best set to thrive from a dovish FED outlook, particularly Asian currencies that should get a boost from successful trade talks while the Chinese administration should be less enthusiastic to depress the Yuan in a climate where they will eager to avoid being seen as manipulating CNY to their advantage.

Dollar Index (DXY)



Source: Bloomberg

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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.

Hard commodities have enjoyed a strong start to the year alongside equities as copper and oil both indicated renewed hope in the global economy, with sanctions on Iran and Venezuela helping to prop up the crude price. The recent reversal of oversupply should see oil prices stay at current levels or edge higher helped along by the general appetite for assets in the wake of looser policy. Precious metals, while not unanimously loved by the investment community, offer an interesting correlation dynamic to equities and gold performed very well in Q4 and has held its value this year. Platinum and Palladium have started to feature more on investor's radar, with the latter returning over 80% between August and March – though its sole use effectively being used for pollution reduction in cars means it is very susceptible to sentiment towards the autos sector and thus doesn't have the unique characteristics of gold.

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ALTERNATIVES								**Uncorrelated assets will play an increasingly important part of a portfolios' asset allocation.**
Precious Metal								Gold seems to have settled around $1300, following a traditional early year rally. Central banks are buying to diversfy USD currency reserves
Hedge Funds								Genuine alternative funds (e.g. Long/short, market neutral etc) that behave in a different manner to traditional assets are a vital source of wealth preservation.
Oil/Commods								After falling 40% from its peak, Brent may well oscillate around $60 as OPEC cuts halt the slide.

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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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