Banque Havilland

Compass

Third Quarter 2018

Contents

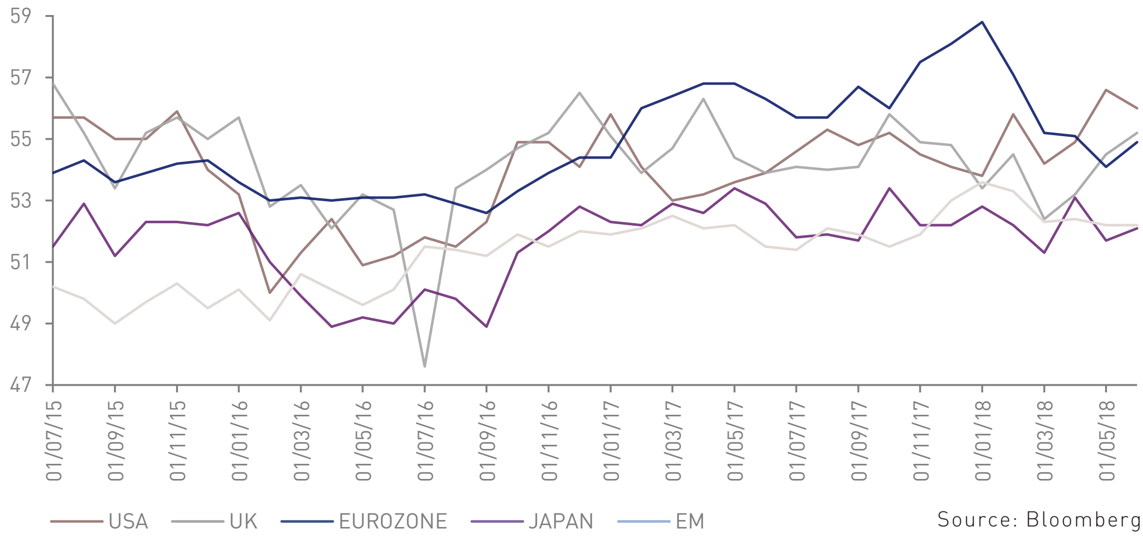
Market Environment

While the extreme swings that markets experienced in the first quarter of 2018 did not quite continue into the second quarter, sensitivity to news flow remains heightened as investors' focus has been diverted from US interest rates and inflation-based concerns to that of more protectionist United States trade policy and familiar threats to European Union harmony emanating from Italy and the migrant crisis. The economic outlook is still sound, with global GDP growth projected at 4% for the next year, though with the fastest period of growth almost certainly behind us now, there are likely to be diminished medium-term returns for investors used to a low-rate environment. Global equities are only just in positive territory this year, though most major exchanges outside of the US are not despite having largely recovered from the wobbles seen in February and March. That the US remains ahead of other regions in terms of growth is likely due to the extra fiscal boost provided by the tax cuts that are effectively extending the US business cycle, though it remains to be seen whether this will prove to be a worthwhile long-term ploy at this late stage of the cycle at a time that the Federal Reserve is raising rates. With respect to rates, it is perhaps more significant to observe the ECB than the FED - while the FED's course of action seems fairly set, the slowing of the economy in Europe could further prevent the ECB from tapering any quicker, especially with inflation still apparently elusive at the moment. As such the divergence in central bank policy between the US and the rest of the world continues to widen - little wonder that the US Dollar has enjoyed such a strong 2018 to date, when the interest rate spread is over 2% between the US and Eurozone and appears to only be going one way.

We continue to be sceptical that inflation will reappear in anger, but it is prudent to protect against it to a certain extent by tilting investment portfolios towards a low-duration stance. Dollar strength, along with the rise in crude oil prices has been one of the notable themes of the year and while there are likely to be continued bouts of strength for the reserve currency in light of the rate differential and temporary risk-off moves, it is difficult to see USD move much higher and we believe opportunities have opened up as a result - emerging market debt for example that has been hit by both oil and Dollar strength.

Undoubtedly the prospect of trade restrictions and retaliatory tariffs are putting a dampener on risk sentiment, despite the generally favourable economic conditions and continued loose monetary policy in most major economies, especially as protectionist rhetoric now seems to be developing into reality as retaliatory tariffs are implemented. We are hopeful that a full trade-war will be avoided, and believe it will be once the initial posturing and predictable tit-for-tat retaliations subside - the US does have a trade deficit with China and Germany in particular, and should these reduce sufficiently it is likely that there will not be a further escalation once the playing field

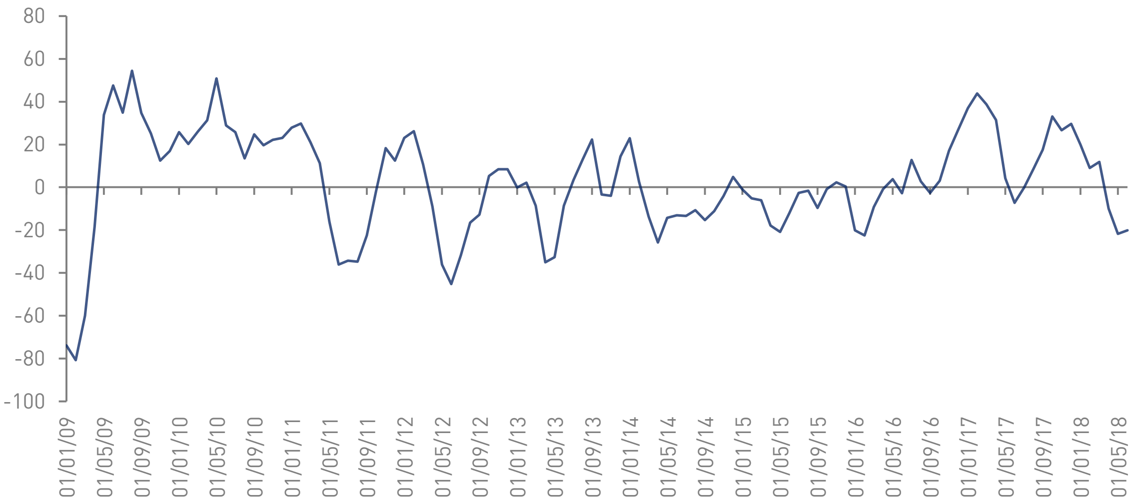
Composite PMI Readings



Source: Bloomberg

has levelled somewhat. Looking at the reaction in the markets to date it already it seems that it is not in the interests of China to escalate tariffs too far - the MSCI China stock index has sold off heavily in recent weeks, down nearly 15% year to date, while the Yuan has lost over 5% since April. If the world ends up following a protectionist route, prices in the shops would be higher and real incomes would be lower while inflation could return which would most probably lead to lower equity markets and lower fixed income prices too. Alongside trade tensions, the new coalition government formed in Italy has reopened old wounds with respect to the structural longevity of the single currency, as many of its official policies are seemingly incompatible with the conditions of EU membership. Italian bond yields remain elevated, especially on a 10yr basis and with the planned spending plans of the government looking to extend the already eye-watering debt to GDP ratio of 130% by a further 6%, the country's relationship with Brussels and global investors looked strained. Assuming neither the Italian political scene nor the global trade tensions mutate into their worst possible outcomes, the solid growth and level inflation path along with the higher but stable oil price give cause for quiet optimism, albeit with lower return expectations than previous years.

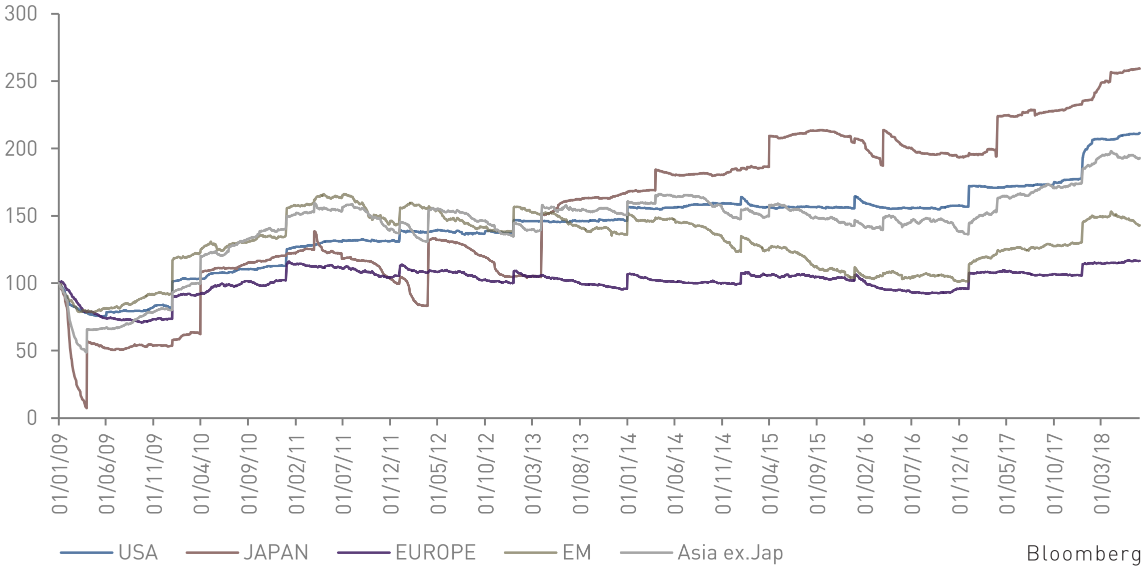
Citi Economic Surpise Index - Global



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.

Earnings Estimates (rebased to 100, 2009)



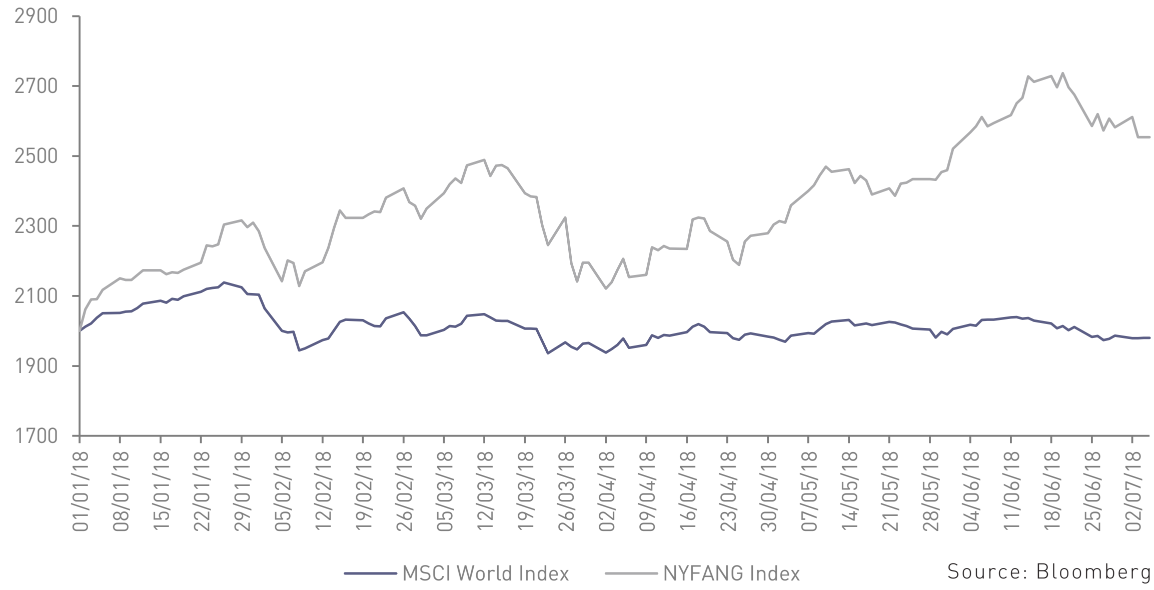
Bloomberg

Equities

Despite the return of volatility in 2018, global equity returns are broadly flat as we move into the second half of the year, (as measured by the MSCI World Index) and we would anticipate this 'sideways' pattern to continue in the coming months meaning profits will be generally harder to come by for investors. So-called 'FANG' stocks have been on a tear - up nearly 30% year to date - and when these companies' performance are stripped out of the wider global index it is clear that the wider picture for stocks is very mixed. Emerging market stocks have suffered the most recently, weighed down by the stronger USD, higher oil price and their sensitivity to the trade-tensions, and likewise European equities which reflect the export-heavy nature of the regions larger companies have also fallen. Perhaps it is no coincidence that the USA's leading trading partners - China, Canada, Mexico, Japan and Germany - are all among the weaker markets, when the US runs a trade deficit with all of them, i.e. tariffs will hurt them the most. The UK's FTSE 100 market, through the pessimism surrounding Brexit having and whipsawed between a 11% sell-off and new all-time highs in May is now largely unchanged in 2018 - with Britain being the only top ten trading partner of the US against which the US runs a surplus.

The Australian and Indian markets are two markets in positive territory, and we have exposure to both via our Asian fund - demonstrating nicely the importance of regional diversification. As above, the tariff situation may not worsen but investors are nervous that the market is too complacent and this lack of conviction is playing out in the markets making it impossible to accurately predict a medium-term pattern, though this does not mean that a crash is coming. Our approach at such times is to hold off making any drastic decisions, but certainly to take advantage of any buying opportunities that arise in our preferred markets due to temporary weakness. Both the US and Europe enjoyed decent corporate earnings seasons in Q1, the monetary environment remains loose for now and global consumers' appetites remain healthy and inflation remains in check - so in all it is a fundamentally favourable environment for equities. However, we have to bear in mind that we are in the latter stages of the business cycle that started in 2009 with full valuations for many markets following years of stellar returns, and as such we do envisage diminished returns going forward and recommend an underweight holding in equities in light of the challenges ahead.

FANG Index vs MSCI World Index 2018



Mega tech stocks have pulled further away from the rest - how long can this last?

		–		=		+		
EQUITIES								**Jittery markets. Global growth is sound, but no obvious catalyst for more significant gains.**
US								Tax cuts boosting earnings. FANG stocks are stretching valuations.
UK								Domestic stocks look cheap, but data softening alongside Europe.
European								Relatively attractive valuations, growth perhaps slowing now, still scope for returns. Supported by ECB loose policy.
Switzerland								As Europe, but we like defensive nature and stable currency.
EM								We favour emerging Asia for long term growth, wary of political risk(eg. Turkey/Argentina) elsewhere. USD strength a headwind.
Japan								Growth has returned. Easy monetrary policies remain. JPY offers diversification.

Bonds

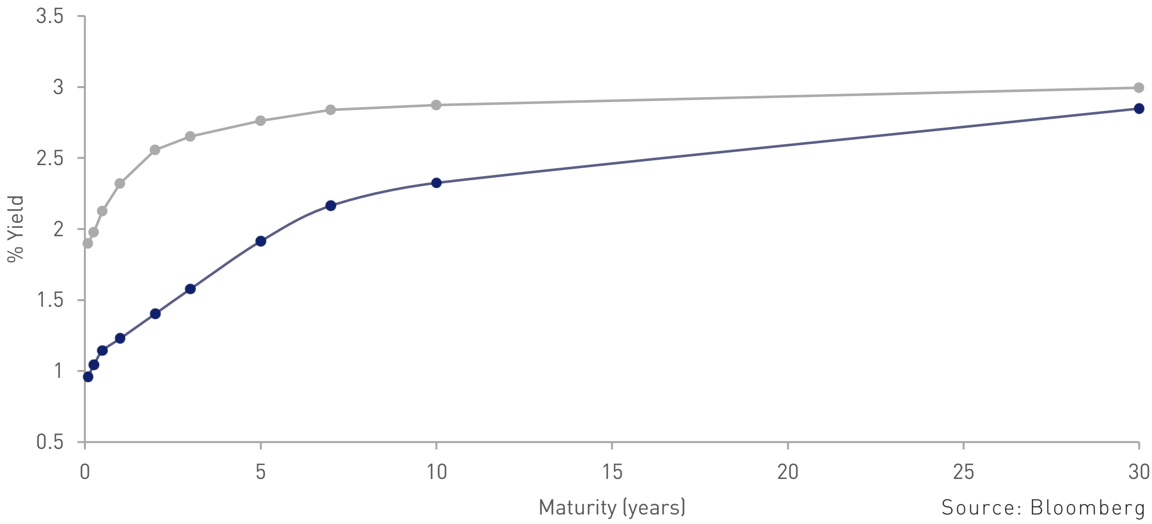
Though equity markets have fluctuated this year, it is the Bond markets that have provided investors with the greatest headaches as we have at times seen some significant spread-widening across all aspects of the asset class. Emerging market debt in particular has been sold due to the prospects of a trade war that would undermine developing nations' companies' profits in exporting to the USA, while country-specific issues in Russia, Turkey and Argentina also pulled the asset class back. As events in Italy unfolded in May, news flow resulted in widening spreads and the repricing of European credit risk. Both investment grade and high yield credit yields increased, and unsurprisingly, peripheral European government bonds were the worst-affected fixed income asset class – we have long avoided direct investment here so the effect on portfolios was limited. In recent weeks the Yield Curve has once more been under the spotlight, as while US 10yr Treasury yields have risen 0.4% this year, the curve has decidedly continued to flatten with the spread between the 2yr and 10yr bonds compressing to nearly 0.3%, and that between the 10yr and 30yr even less still. Essentially, investors are not being rewarded for taking on extra duration risk while also exposing themselves to negative real yields, and should the near term rates overtake the long term yields, history would suggest a recession is round the corner. The spread between US and European Sovereign debt has widened, as the central bank interest rate path is starting to significantly diverge, exacerbated by the Italian political risk and latterly the EU migrant crisis. With the Bank of England postponing its intended May rate-rise, and the BOJ and ECB ultimately continuing their accommodative policies despite some rhetoric to the contrary – only the US is on the road to rate normalisation, and sovereign bond prices are reflecting this. From an investment point of view, we only really like the US in the sovereign space, but for non USD investors there is little value in owning government debt with such low yields. Providing USD strength has run its course for now, selective Emerging Market bonds will present opportunities and we prefer the short duration end of the market to negate the greater credit risk involved. The core exposure of a bond portfolio remains best invested in liquid investment grade debt, as default levels are low but with some yield pickup over government bonds, though European yields remain unattractive at less than a percent for anything under 5yrs – while holding non home-currency corporate debt makes little sense unless one has a strong currency view. Overall, Bonds should currently be considered as a wealth preservation tool while inflation remains muted, with little income potential on a historical basis. Returning inflation remains a long-term, if not imminent, threat to the asset class.

Two Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	12/05/2019	-0.81
FINLAND	12/03/2019	-0.68
NETHERLANDS	15/09/2018	-0.66
GERMANY	14/06/2019	-0.66
AUSTRIA	15/11/2018	-0.60
DENMARK	15/07/2019	-0.58
BELGIUM	15/03/2019	-0.56
IRELAND	28/11/2018	-0.55
SWEDEN	28/09/2019	-0.52
FRANCE	25/02/2020	-0.48
SPAIN	18/06/2019	-0.25
JAPAN	06/02/2019	-0.14
PORTUGAL	30/04/2019	-0.13
ISRAEL	11/04/2019	0.38
BRITAIN	22/01/2019	0.73
ITALY	15/04/2019	0.74
HONG KONG	30/03/2019	1.73
NEW ZEALAND	14/06/2019	1.77
SINGAPORE	10/07/2018	1.89
CANADA	25/06/2019	1.91
AUSTRALIA	31/05/2019	2.01
UNITED STATES	22/07/2019	2.55
ICELAND	25/07/2019	4.67

Source: Bloomberg

US Treasury Yield Curve 2018 VS 2017



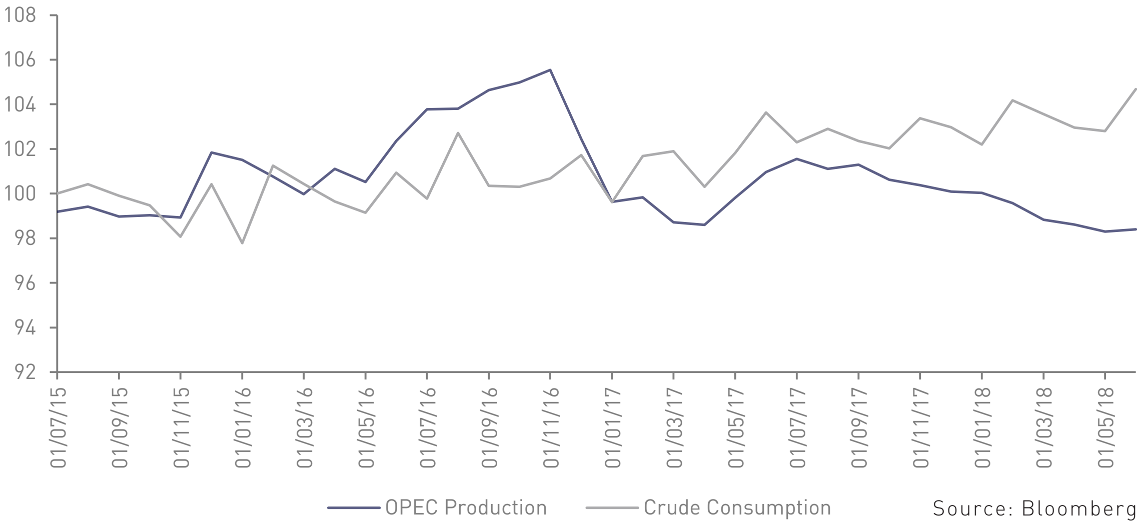
The curve has 'flattened' significantly over the past year - shorter dated yields have risen, but longer dated yields have stayed the same.

		–		=		+		
FIXED INCOME								**Benchmark yields have retreated from highs - inflation fears have temporarily waned.**
Sovereign Bonds								Low yields remain unattractive, especially European.
Investment Grade Bonds								Our core exposure to bonds. Credit risk is low, yields are unexciting but preferable to Sovereigns. Avoid currency risk.
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.

Commodities

The rising price of Crude Oil has been one of the major developments of the year, with both WTI and Brent contracts up over 20% at the time of writing, as OPEC and Russia's 2016 deal to reduce production appears to have worked, while Venezuela and Iran's output has effectively been taken offline by sanctions. US Shale producers have been keeping a lid on oil prices over the past few years as they became more efficient and were able to increase production at a faster rate, however, there have been reports that the support infrastructure of the Permian Basin is beginning to creak with capacity constriction. There is no shortage of oil in the area, but the transport system that delivers the oil from the shale fields to its customers is badly stretched and is struggling to keep up with demand - suggesting the tight supply/demand balance is tilting towards higher prices. While President Trump is no doubt keen to see lower fuel prices moving towards the mid-term elections, depending how long it takes to increase the US shale pipeline he may be resigned to seeing the crude price at similar or higher levels to now. Industrial metals, such as copper had been tipped to rise in line with global inflation and the robust growth outlook, and this looked to be realised in early June until the trade war fears knocked 10% off its value in a number of days. Precious metals have fared little better, and amidst the volatility Gold and Silver are both down over 5% this year when one might have expected investors to allocate to these safe-havens - once again it may be indicative of how fears of rising prices have fallen away since the start of the year, with Gold's traditional inflation - hedge properties not required.

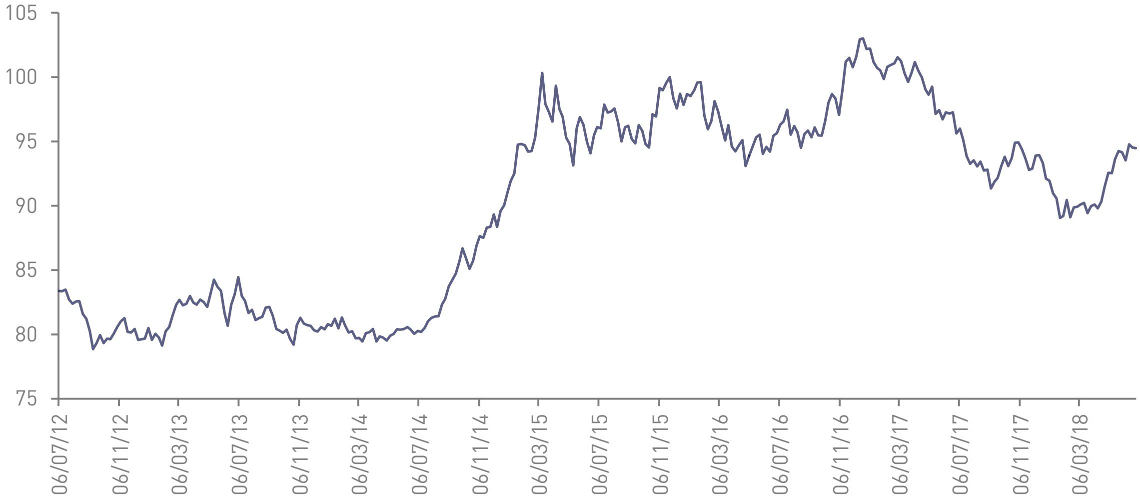
Oil: Demand is beating Supply = higher prices



		–		=		+		
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.

Currencies

DXY (US Dollar Index)



Source: Bloomberg

		—		=		+		
CURRENCY								**USD has strengthened in 2018 from its recent malaise - strong US economy coupled with market jitters, and central bank divergence.**
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.
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.
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 loose policy.
Swiss Franc (CHF)			■					Close to parity and ranging v USD, stronger v EUR. Seen fear-based inflows. Negative rates and dovish SNB restrict upside.

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