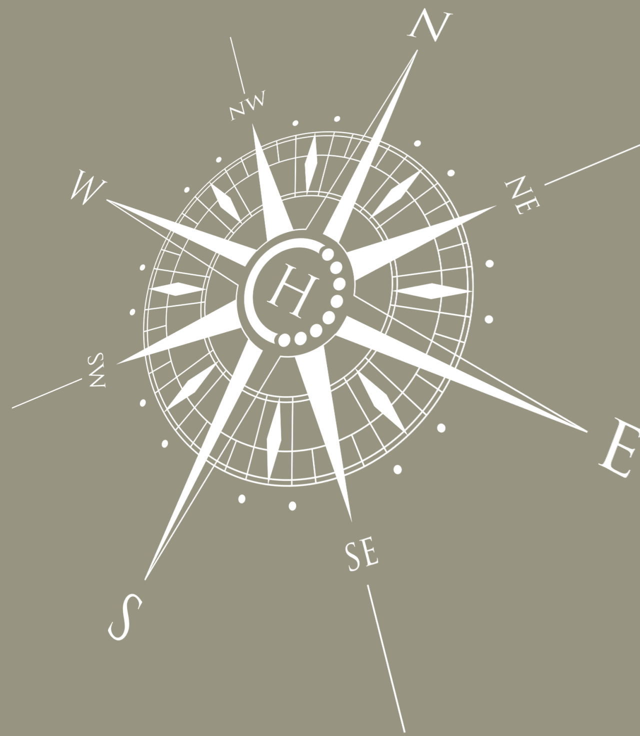

Banque Havilland
Compass
Fourth Quarter 2019

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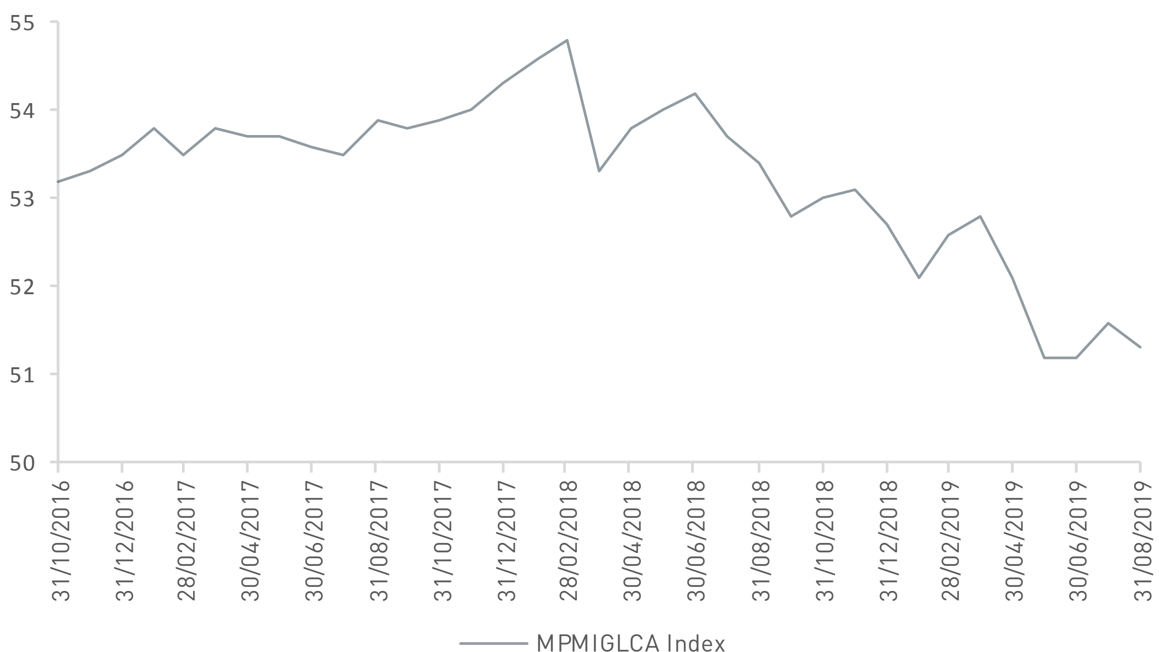
Market Environment

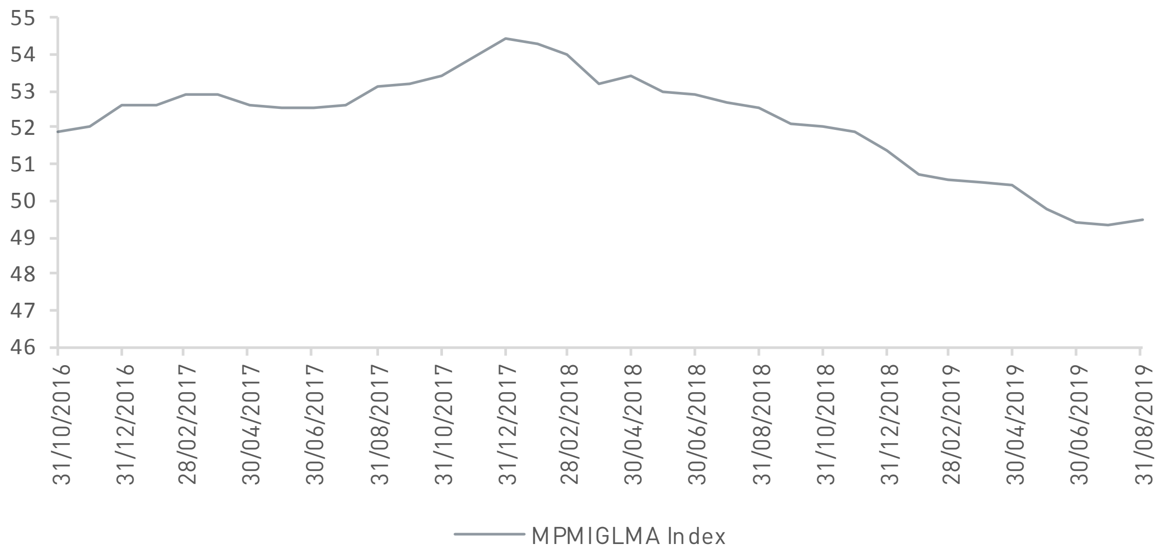
The overarching theme that investors have been tackling in 2019 has been how to weigh up the slow grinding decline in global growth and ever-present geopolitical risk that threatens asset prices, with the continuing premise of central bank stimulus and interest rate cuts that is supporting them. This theme has been taken to new extremes in recent weeks, as on the one hand trouble flared in the Middle East in the form of the drone attack on the Saudi Arabian oil fields at a time when the US and China trade talks are deteriorating (again), the Brexit 'deadline' of 31st October approaches with little in the way of a predictable outcome and civil unrest is unsettling the key trading and financial hub of Hong Kong. On the other hand the Federal Reserve reduced the target rate by another 0.25% in their September meeting as widely expected (some might say required) by the markets, the ECB also cut by 0.10% as Mario Draghi signed off his last meeting before passing the baton to Christine Lagarde with an extension of his 'whatever it takes' mantra, that was widely reported by the media as 'QE infinity'. Meanwhile Global Manufacturing PMI data is languishing below the 50 reading mark – indicating no expansion, epitomised by China which has for so long been the engine-room for the world's economic growth. The conundrum for investors over how bullish or defensive to be is further complicated by the record low yields on offer in the bond market – an asset class that would ordinarily be the go-to allocation at an advanced stage of a business cycle when the prospects for growth are clearly deteriorating. Indeed, the case for investing in bonds as standalone assets, many of which are negatively yielding, is a difficult one to make - though they still have a valuable role within the context of a diversified portfolio alongside equities and more alternative assets. The recent oil shock which saw the Brent benchmark soar by as much as 20% on the day before falling back, is significant for reasons beyond the simple cost of crude that affects so many people, companies and economies – because it served as a fierce reminder that the low-inflationary environment that markets have become accustomed to are not a sure thing. Much focus has been on the likelihood of deflationary shocks such as China 'exporting deflation' or the Eurozone slowdown, and this has provided central banks with the comfort that enables them to pursue loose policy that is so favourable to the bond markets, and with the emergence of the US Shale industry in recent years to keep a lid on a supply led oil rises – it was easy to become complacent about the risks of an oil spike and the quick effect this could have on global prices. Though the early signs are

JPMorgan Global Composite PMI



Composite (including services) PMI data is slowing but still growing (above 50). Source: Bloomberg

JPMorgan Global Manufacturing PMI

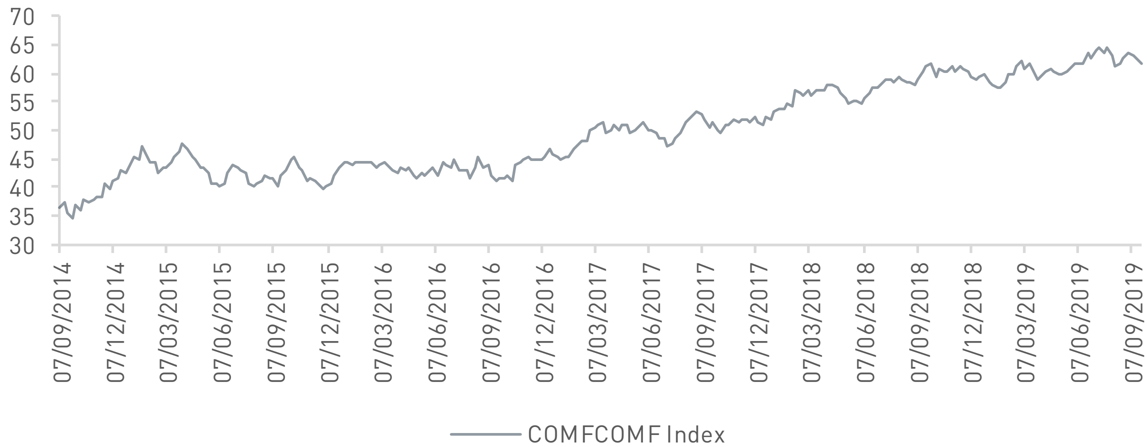


Manufacturing PMI is below 50, i.e is contracting. Source: Bloomberg

the oil price is pretty stable in the mid $60's per barrel (assuming the extent of the attacks on the Aramco facilities have not been too downplayed) it is important to have some protection against a rise inflation within a portfolio as should it start to rise, negative or low yielding debt suddenly looks very unappealing indeed and bond prices could be subject to a nasty pullback. At a time when one of the last strongholds of economies across the world is that of robust consumer demand and confidence, anything that could dent this when data being reported in other areas is already mediocre may well jolt sentiment to the downside. For now, oil remains a fifth lower than it was a year ago and the effects of the attack itself looks to have been contained in terms of supply disruption, though any subsequent conflict between the US and Iran that results from it may well see the price of crude increase again.

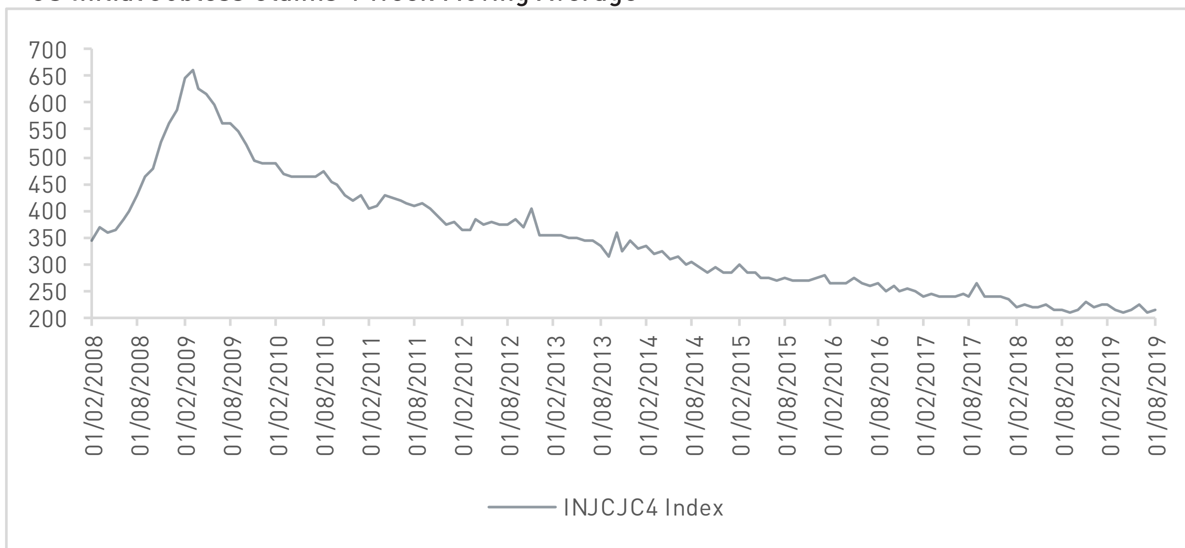
Going back to central banks and it is not just the FED and the ECB that are pursuing accommodative policy as in August nations as diverse as New Zealand, Malaysia and Turkey cut rates - in fact 19 central banks have cut rates in 2019 so it is clear to see that a real will exists to see off a recession with plenty of jostling to ensure that each nation maintains competitiveness in terms of exports and currency. There are concerns now that some policy makers are nearing the end of the line in terms of what monetary policy can achieve, as demonstrated by the ECB as it seemed reticent to cut rates too deeply into negative territory, just opting for a -0.1% move (plus more QE) and instead allowing commercial banks to deposit more of their reserves with the central bank for 0% while borrowing at negative rates from each other. This could provide European banks with a lifeline in the shape of a risk free return, that in turn could boost the European economy and asset prices as they lend more at cheaper rates. There is also greater expectation now that governments will step in with fiscal measures to help stimulate growth where central banks are running out of room, and this should provide investors with more reasons to be cheerful. Even Germany appears to be flirting with the idea of loosening the purse strings in order to avoid a recession in the face of the trade-slowdown that is especially damaging to the export-heavy country, and while the $59 Billion 'green' infrastructure plan is not a threat to their sacred balanced budget it is a significant acknowledgment that fiscal action may be required. A very poor PMI reading in late September may well initiate this. In Britain, the weakened conservative government has announced a glut of spending to accommodate for Brexit, though whether or not it stays in power long enough to implement these is another matter! Even then, a more socialist successor is likely who also won't be shy when it comes to spending. In the US, the Trump administration has long given up pretending to be fiscally conservative and is stretching the US deficit, which it will presumably continue to do through to the next election in order to avoid an untimely American slowdown. From an investment perspective, what will determine the effectiveness of these market-friendly policies, is quite how 'priced in' they already are and whether the markets' expectations of infinite stimulus be it monetary or fiscal can be continually met.

US Consumer Confidence



As measured by the Bloomberg US Weekly Consumer Comfort Index. Source: Bloomberg

US Initial Jobless Claims 4 Week Moving Average



Unemployment continues to decrease in this market cycle. Source: Bloomberg

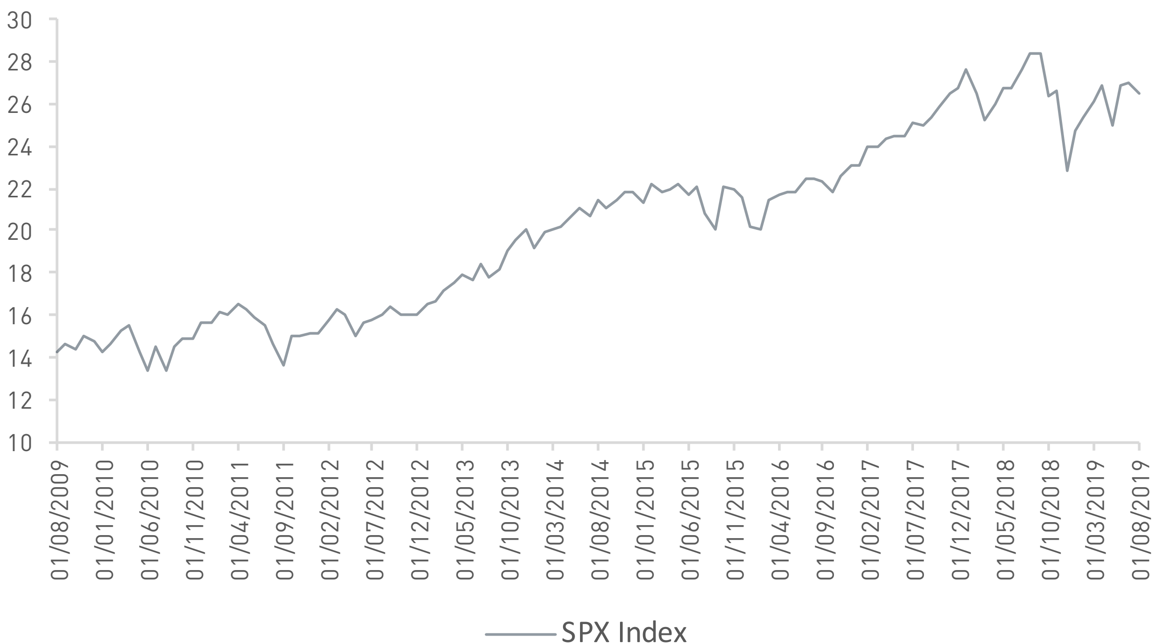
As debt grows and yields move lower, we have written before about the dangers of markets becoming addicted to lower and negative rates and the tantrum witnessed at the end of 2018 resulting from 'one rate rise too many' perhaps demonstrates the precarious situation. Over 30% of all global bonds are trading with sub-zero yields, and fears are growing that Europe and maybe even the US are entering a period of 'Japanification', a term that refers to Japans' long battle against deflation and slow growth in spite of extensive monetary stimulus that simply doesn't work in terms of stimulating the real economy. However, this does not mean that there are not opportunities within this environment, indeed Japan itself is one of our preferred markets for equities with an attractive valuation and strong currency that is appealing to foreign investors. As mentioned earlier, the global consumer sentiment remains high and employment data is also very strong which should support a good chunk of the equity market, furthermore the Citi Economic Surprise Index has shown an impressive spike at the end of the summer that suggests markets and investors are more realistic in their assessments and expectations than bond yields suggest. Furthermore the dreaded recession indicator that is the inverted yield curve which appeared in US, EU and UK bond markets earlier in the summer have now since 'un-inverted', and while it is quite possible this situation may revert again there is no sense of overt pessimism as things stand. Even in an uncertain market environment where asset prices are being pushed to record territory by a concerted programme of stimulus we are able to identify opportunities and reasonably-priced parts of the markets to invest in for the long term.

EQUITIES

As the US-China trade dispute rumbles on into the final quarter of the year and a 'no deal' Brexit remains in play, the prospects for global trade look gloomy and it is hard to be too optimistic that corporate earnings can move higher when challenged by new tariffs and disrupted supply channels, and with global stocks (as represented by the MSCI World Index) back at all time high prices we are led to a cautious/underweight position in stocks. While some comfort can be taken from valuations being a little way off their highs and not at full strength, the discount is not sufficient enough to encourage taking on more risk at this point. A volatile summer for global stocks as traders reacted to the news/tweet flow culminated in an abrupt rotation of styles at the beginning of September as cyclical stocks such as autos, banks and miners in Europe finally enjoyed some time in the sun as bargain hunters looked for cheap companies suggesting that value stocks might be starting to catch up with the rest of the market. This seems to have been short-lived as a slew of weak data from France and Germany together with the oil-shock, triggered another retreat towards defensive 'bond proxy' stocks, and while low yields in the bond markets certainly make stocks relatively more appealing, it is also serving to distort the equity markets. It is well known that the US indices are being dragged higher by a small cohort of large-cap stocks, and size has been the leading factor in 2019 – there is a big dispersion between small caps and large caps, while value stocks continues to lag. This has led to defensive sectors such as consumer staples and utilities having particularly high valuations, as well as the tech sector, so we are wary of chasing return here. Likewise companies that have been subject to earnings revisions have also outperformed their peers but with 2020 earnings estimates still looking over optimistic it would not be sensible to continue to chase this theme.

As such we naturally find ourselves drawn towards the cheaper parts of the market both in terms of geography and style, while of course being conscious of avoiding things that are cheap for good reason. European stocks for example are valued less than their US counterparts, but with structural issues such as the threat of tariffs over car exports, banks being squeezed by negative interest rates and the undeniably weak manufacturing/industrial data there is little in the way of a catalyst to suggest a move higher for continental stocks. There are hopes that German fiscal stimulus and a weaker Euro could provide a fillip for European stocks, but we think this merely balances out the obstacles for stocks rather an offer a solid reason to buy more. The UK market has been falling behind the continental European and American indices for

S&500 Index CAPE/Shiller Price Earning Ratio



Global equity valuations are elevated though a little way off 2018's highs. Source: Bloomberg

some time on a total return basis and also in terms of valuation and this is predominantly why it is our preferred area of exposure within our European basket of equities with a forward PE value of 12X compared with 13.4x. Moreover, we believe the weakness in UK assets is largely a result of uncertainty over the nature and timing of Brexit rather than over any long-term concerns for corporate Britain. We continue to like Japanese and Swiss equity markets as these two markets are rather defensive from a sectorial and balance-sheet-quality point of view. At the same time, they bring some diversification characteristics through the risk-off Japanese yen and Swiss franc currencies. With regards to US stocks, at top level they are more highly valued than other developed markets but due to the divergence in the market between large-cap and small-cap, and between growth and value there is still opportunity to invest, and the economic growth and dynamism in the states currently remains ahead, and having USD exposure in EUR and GBP portfolios is no bad thing in the current market environment. The 10 year moving average PE valuation for US small cap stocks is not historically high, especially compared with their larger counterparts so we are comfortable having an exposure to smaller companies within our USD portfolios. The US earnings season has been a little better than many expected but the trade war effects are starting to materialize that potentially undermines the forward earnings outlook, despite a resilient economic backdrop. We retain our moderate underweight exposure to the equity markets, being careful to position portfolios for the late part of the business cycle.

		–		=		+		
EQUITIES								**Stocks are at records high and valuations full, though off the highs of 2018. Growth is slowing, but prices are supported by monetary stimulus.**
US								The most expensive market at top line level, with a small number of companies dragging the indeices higher. Value and small cap are lagging.
UK								UK assets have been left behind since the EU referendum, but are now attractively priced for a recovery if and when Brexit uncertainty clears. High dividends.
European								Earnings and growth are slowing, with Germany in particular stuggling with the stalling of global trade. France and Spain on the mend though.
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								We favour emerging Asia with too much political risk elsewhere, trade tensions prevent us from being too bullish. Avoid South America.
Japan								Very attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Data has been anaemic, and BOJ stimulus is substantial.

Fixed Income

With over 30% of the world's bond supply in negatively yielding territory, investors have been required to change the way they view fixed-income as an asset class – with yields at zero or less, these bonds no longer offer any income and are essentially rendered directional bets. Since the Federal Reserve about-turned at the end of 2018, this has been rather a one-way bet even as yields crossed the zero threshold, and the fact that the US 7-10yr treasury Index is up a further 10% in 2019 is really quite remarkable, though not as remarkable as its German equivalent having a near 7% total return despite having dropped below zero as long ago as February. This of course leads to the question of how much further bonds can rise, and the answer is they probably will continue to do so until the US cuts rates down to zero, all else being equal. Ultimately, it is difficult to construct a portfolio of bonds that will protect capital in the short-term context of a deteriorating economic picture and elevated geopolitical risk while also avoiding long-term capital erosion resulting from negative real (taking inflation into consideration) rates. We are willing to maintain some high-quality rate exposure in portfolios for balancing purposes i.e. in a multi-asset portfolio where the Treasuries can counter balance the equity risk, at least in the short term where the traditional inverse risk relationship still holds true. The market is expecting at least one more rate cut by the FED in 2019, with anticipation of more accommodative policy from the ECB indefinitely, however, it is the risk of disappointment (i.e. the markets expect too much) that leads us to a moderate underweight in fixed income assets as along with the scope for an unforeseen inflation spike, the risks are asymmetric. By this we mean that the directional returns on offer by chasing the last few basis points of the current rate cutting cycle, are not sufficient enough to justify a larger exposure to bonds while the risk of a violent sell-off exists if Jerome Powell fails to manage expectations. Compared to IG credit (where we are cautious on the BBB space, which is suspiciously crowded we prefer securitized credit sectors such as asset-backed securities (ABS), commercial mortgage-backed securities (MBS) and residential mortgage-backed securities that can benefit from a still strong consumer sector. We also see selective opportunities in US high yield on the BB and B space that provide better liquidity profiles, but still avoiding the more volatile end of the spectrum. In European credit, we are happy to hold some quality credit due to the spread pickup over EU Sovereigns, and a passive (ETF) approach here makes sense due to the low yields but higher costs of active strategies. Likewise, a selective, hard-currency approach to Emerging market debt, avoiding duration and low-credit names offers an extra bit of income without compromising too much on quality. Likewise the income received from asset

Two Year Bond Yields Global

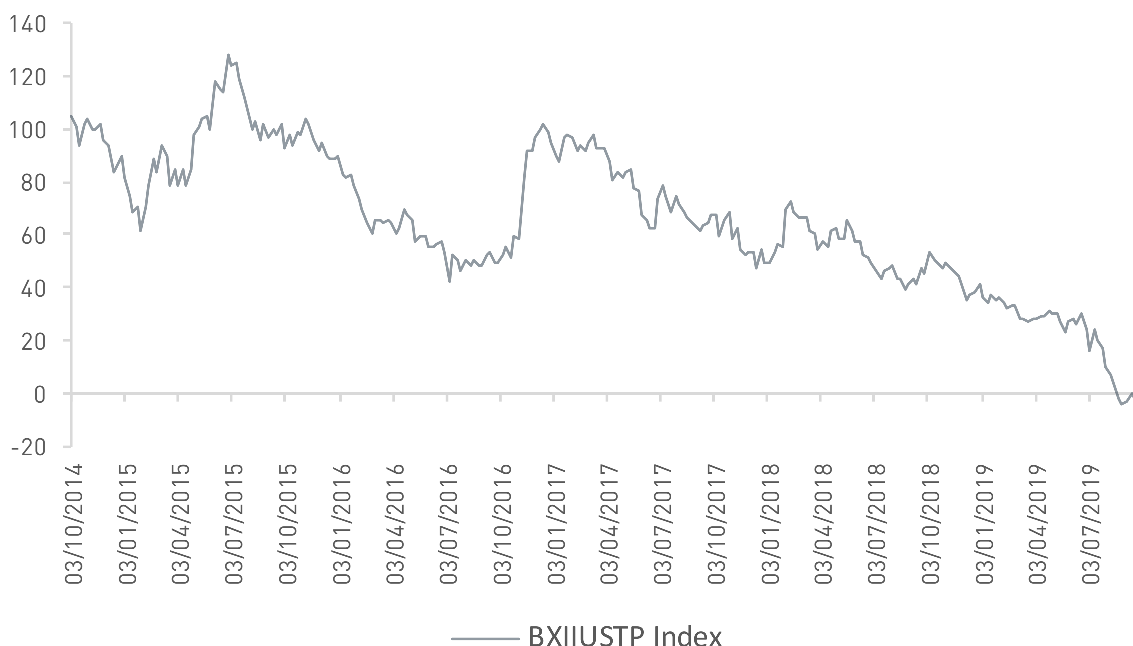
COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	28/04/2021	-0.97
DENMARK	15/11/2022	-0.83
NETHERLANDS	15/07/2021	-0.77
GERMANY	10/09/2021	-0.77
FINLAND	15/04/2021	-0.72
AUSTRIA	15/09/2021	-0.71
FRANCE	25/02/2021	-0.71
BELGIUM	28/09/2021	-0.69
SWEDEN	01/12/2020	-0.61
PORTUGAL	15/04/2021	-0.61
SPAIN	30/07/2021	-0.52
JAPAN	01/09/2021	-0.33

COUNTRY	MATURITY	YIELD + / -
ITALY	15/04/2021	-0.26
ISRAEL	30/04/2021	0.17
BRITAIN	07/09/2021	0.37
AUSTRALIA	15/05/2021	0.72
NEW ZEALAND	15/05/2021	0.79
NORWAY	25/05/2021	1.17
HONG KONG	23/08/2021	1.53
CANADA	01/08/2021	1.57
SINGAPORE	01/10/2021	1.63
UNITED STATES	30/09/2021	1.66
ICELAND	05/02/2020	3.19

Source: Bloomberg

backed bonds is worthwhile, though we choose only to hold European property debt as the protection for lenders in the region is far more substantial than for their counterparts in the US. The US High Yield market remains relatively attractive due to the low default levels in corporate America though the high-correlation of this asset class with equities means it is prudent not to take too heavy a position within the context of a multi-asset class portfolio. In short with yields and rates seemingly on a one-way path at the moment it, we retain the view that investors will increasingly need to revise down their return expectations within fixed income.

US Treasury 2yr vs 10yr Yield Curve



When this chart drops below zero, the 10yr Treasury Bond is yielding less than the 2yr, i.e. the yield curve is inverted.

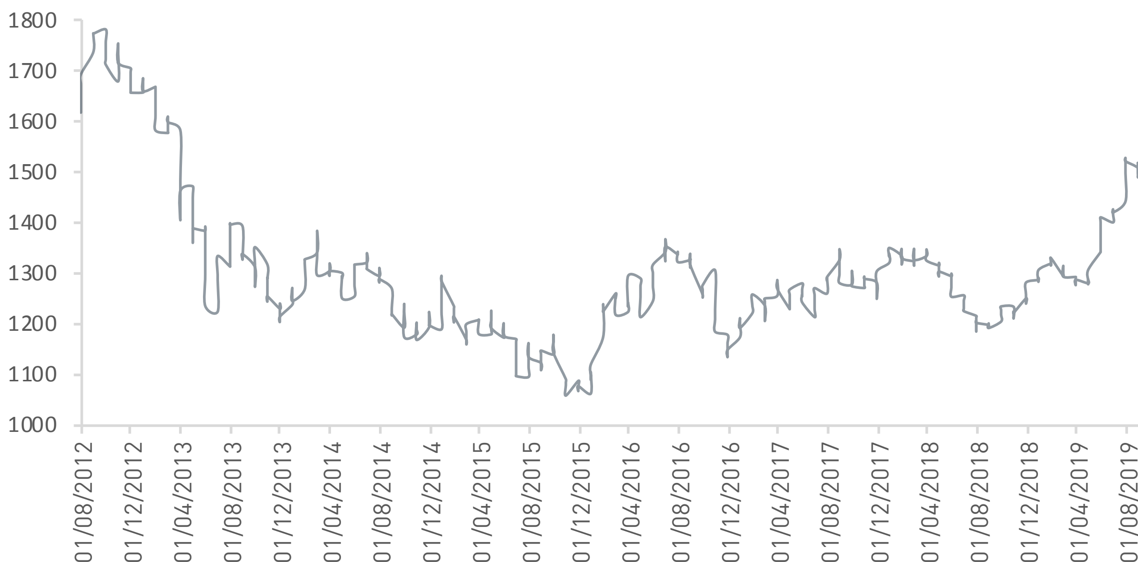
Source: Bloomberg

		–		=		+		
FIXED INCOME			■					**Expectations of renewed impetus from Central Banks and slowing growth are pushing yields to their limits.**
Sovereign Bonds			■					Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Investment 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. Trade war risks. Hard currency for now.

Commodities and Currencies

Our faith in precious metals as an essential diversification tool has been repaid this year, as both gold and silver have contributed well to portfolios this year following a tough 2018, and importantly have tended to surge in value during times of market stress, while of course the lack of income that is foreseeable for other traditional safe-havens such as bonds makes gold all the more relatively appealing as a store of value. Where gold has advanced, silver has followed this year albeit with something of a lag and is living up to its reputation as gold's more volatile younger sibling, and the $1500 mark seems to be something of a new base for the yellow metal. It is noticeable too, that the only asset that virtually all commentators and analysts have been able to write positively about in the past few months has been gold, mainly in light of the stretched nature of the bond and equity markets. That the US Dollar has stayed strong throughout the year makes gold's surge even more prescient, as usually one would expect the weakness in one to be accompanied by strength in the other and vice versa. It is unsurprising that the relative appeal of the world's reserve currency is elevated at the moment, when one considers that both GBP and EUR are riddled with their own problems while elsewhere both developed and emerging economies are cutting rates to avoid being left uncompetitive in a slowing growth and trade backdrop. Currencies especially exposed to trade such as the Australian and Kiwi dollar are looking especially weak, while only the Japanese Yen and Swiss Franc offer any upside due to their established safe harbour, defensive status – which indeed is why we like to hold some exposure to these two currencies in portfolios. In Switzerland there is growing political opposition to negative rates and the unknown long-term effects of such policy, while the SNB will be keen to avoid the 'currency manipulator' tag by the US and as such it would seem the Franc would not be on course to weaken any further. We started the year, thinking (along with many others) the dollar would tail off towards the end of the year but as the on and off trade discussions between the US and China have showed no signs of a conclusion, emerging market currencies will likely remain supressed, particularly with the Chinese having little incentive to support the Yuan any higher making exports less competitive at a time tariffs are being imposed. With caution creeping in to the global economy, the Dollar is likely to remain preferred to other currencies and conversely a stronger USD makes growth more difficult and commodities more expensive – in itself a headwind, though there is a hope that the President will pull a trade-deal rabbit out of a hat as the countdown to the next US election approaches. This scenario materialising at a time when stimulus is being ramped up is at least one cause for optimism.

Gold Spot Price 2012-2019



Gold has surged in 2019 on the expectation of continued stimulus, lower interest rates and heightened geopolitical risk.

Source: Bloomberg

	–	=	+	
CURRENCIES				**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.

	–	=	+	
ALTERNATIVES				**Uncorrelated assets will play an increasingly important part of a portfolios' asset allocation.**
Precious Metal				Gold has come back into fashion in light of lower yields and fears of a global economic slowdown. Techically well-supported.
Hedge Funds				Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation. We are looking increasingly at trend-following strategies.
Oil/Commods				$60 a barrel for Crude seems to be a reference point. Shale supply increases are tempered by geopolitical risk. Copper and others will likely reflect global economic health.

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