MARKET PERSPECTIVES

OCTOBER 2018

THE LAST QUARTER...

- Equities march on, led by the US market, which is now in its longest ever bull run (up 7.7% on the quarter)
- The NASDAQ index surpasses 8,000 as Apple and Amazon both breach $1 trillion market capitalisation
- Facebook falls 19% on the day it announces its Q2 figures
- Asia and Emerging Markets remain in the doldrums: Hong Kong follows China into official bear market territory (i.e. 20% off its recent high)
- Bond yields rise as the US Federal Reserve raises interest rates; the Bank of England raises the Base Rate to 0.75%
- The UK government sees its biggest monthly surplus for 18 years – £2bn
- Turkish interest rates rise to 24%
- South Africa enters recession

"An increase of [import] duties shall tend to aid… [manufacturing]; they will serve to promote essentially the industry, the wealth, the strength, the independence, and the substantial prosperity of the country."

Alexander Hamilton, Founding Father, 1792

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

The interest rate cycle marches on…

We have been used to an environment of falling interest rates for many years. However, ever since the US Federal Reserve raised rates in late 2015, evidence has been accumulating that the cycle really has turned. The US has gone on to raise rates several more times and the yield curve has flattened; the UK, more cautious than normal because it is so bedevilled by Brexit, has also raised its base rate twice. Whilst the other major central banks (i.e. in Japan, the Eurozone and Switzerland) have yet to move off ultra-low (actually negative) levels, it is clear from looking at their bond markets that the direction of travel is up, even if some central bankers are not yet ready to play their part on this march towards normalisation. The interest rate cycle has been clouded in recent years not only by the unprecedented phenomenon of negative rates, but also by quantitative easing (QE), whereby central banks loosened monetary policy by purchasing chiefly government bonds in order to release cash into the system. Taking the impact of QE into account indicates that rates were effectively negative long before 2016. Some research suggests that world short rates (as measured by looking at a weighted average of US, Eurozone, UK and Japanese bank rates) first went negative in March 2009, troughing at the equivalent of nearly -4.7% in April 2013. Since then, as QE has gradually been wound down and more latterly as bank rates have begun to go up, this super-normal liquidity has contracted such that the current state of play is only just equivalent to a fractionally positive rate.

…and QE is gradually being unwound.

Looking at QE on its own, the major central banks are in aggregate reducing quantitative easing. Aggregate QE peaked in February of this year at 37.3% of GDP. As at the end of August, the figure has dropped marginally to 37.0%. If the European Central Bank follows through on its plan to end QE and if the US Federal Reserve increases its asset sales (i.e. reversing the asset purchases by which QE is defined) from $40bn a month to $50bn a month, then this ratio will fall more markedly.

This is not necessarily bearish for share prices….

The fact is that liquidity has been tightening for some time now: nearly three years if you just look at central bank headline rates as expressed by US Federal Funds, or over five years if you adjust for the impact of QE being unwound. This headwind has caused many commentators to be bearish about share prices as rising yields combined with tightening liquidity make stocks look more expensive relative to cash & bonds, drawing money out of the former into the latter. However, we feel that it is important to note that interest rates remain very low by historical standards: taking into account inflation we calculate that the global real short rate is equivalent to -2.25%, which is the same level as it was in the dark days of 2010 and more negative than it was in 2015. The conclusion can be drawn from this is that monetary policy remains very stimulative and central banks (especially in the euro area and the UK) are extremely reluctant to turn off the taps.

…especially as other measures of credit conditions are benign.

There are other ways to measure how accommodative or restrictive financial conditions are aside from monetary policy. The Chicago Fed National Financial Conditions Index (NFCI) provides a comprehensive weekly update on US financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI, which dates back to 1971, have historically been associated with tighter-than-average financial conditions, while negative values have been associated with looser-than-average financial conditions. The breadth of this measure means that it is a useful cross-check to the more visible indicator that is central bank monetary policy. The NFCI's latest reading is near its lowest ever; previous low points, slightly below current levels and seen in 1976 and 1993, presaged some years of economic expansion before conditions tightened materially and the next recession struck. On this basis we think there is some way to go before tightening financial conditions threaten the economic recovery.

Source: Reserve Bank of New Zealand, Bloomberg, Waverton

Sentiment is poor.

Monetary indicators are all very well, but what is happening in the real world? The UK is afflicted by an intractable gloom surrounding Brexit and the accompanying political outlook, both of which look as though they will surely get worse before they get better. As far as this country is concerned, pessimism is so deeply entrenched that the discounted valuation of stocks relative to gilts is on a par with what it was in the dark days of December 1940. Europe too has its own issues: quite apart from the domestic uncertainties in Italy, Germany, Poland and so on, there is no question that the European economy would be badly hurt by a disorderly Brexit. Pessimism is also affecting Asian stock markets, with all emerging markets in danger of being tarred with the same brush as Argentina and Turkey.

However, there is very little sign of an impending economic downturn.

However, in spite of this poor sentiment, not only are GDP growth rates around the world holding up, but estimates for 2019 and 2020 have barely moved. The US growth rate is expected to slow down as the boost from tax cuts in 2018 unwinds, and Chinese growth continues to moderate slightly – but that is nothing new and only to be expected given that it is a large economy growing at over 6%. We are nine years into a period of economic expansion, so it is natural to be looking for signs that the next recession may be around the corner. We must remember that the recovery in the early years following the global financial crisis was anaemic by the standards of past cycles: accordingly, there is probably more spare capacity in the system than there would normally be so long after the last recession, which partly explains why consumer price inflation has remained relatively subdued (and therefore interest rates have stayed low). The key indicators which we might expect to turn down in advance of recession (such as the US leading and coincident indicators) are still pointing upwards. Credit spreads, whilst off their lows, look benign. The United States' NFIB Small Business Optimism index has just set a new record in its 45 year history; the previous occasions it was near these levels was in 1983, as 'Reaganomics' took hold, and 2004 – half way between recessions.

Aggregate earnings growth looks to be robust…

All of this translates into 11% global earnings growth this year, followed by 11% next year and 10% in 2020 (the 'bottom-up' driven collective earnings estimates produced by company research analysts around the world). It is true that, more often than not, these estimates are subject to some downgrades as time progresses. The short-term picture is apt to be distorted by currency movements but in aggregate 2018 earnings estimates have been very stable (i.e. not subject to downgrades) since they first entered analysts' consciousness in early 2016; likewise global earnings estimates for 2019. Oddly enough rising commodity prices tend to be positive for earnings estimates, at least in the initial years, as the operational gearing of the big commodity producers rewards large index components like Royal Dutch Shell and Exxon Mobil. Whilst the technology sector has been getting all the headlines as far as earnings growth is concerned, one should note that the energy sector is accounting for approximately one third of this year's global earnings growth.

…but we must be vigilant for downgrades

Cognisant as we are that the aggregate numbers are prone to be downgraded over time, we consider earnings expectations for the companies we invest in very carefully. Whilst 2-3% downgrades across the board might be thought of as entirely manageable in the absence of a systemic problem or unusually high valuations (neither of which we think are an issue at the present time), in practice the knife falls very hard on some sectors, and not at all on other sectors. For example, steel manufactures will quickly go into loss in an environment of rising iron ore and energy prices, whereas the software sector won't be affected (in the first order, anyway). That is why one of the attributes we look for in companies is a sustainable competitive advantage, where being a 'price taker' entirely reliant on a benign macro-economic environment is unlikely to qualify. As a recession indicator, our research suggests that an oil price rising over 90% in one year presents a big red flag: as things stand, although the oil price is at a four year high, it's only up 44% over the last twelve months and thus far its appreciation has constituted a steady progression rather than a shock.

United States NFIB Small Business Optimism Index 1974 - 2018

Source: Bloomberg

TOTAL RETURN INDICES TO 30TH SEPTEMBER 2018

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	-1.8%	-1.6%	-1.4%	0.6%
Citigroup World Govt Bond Index	-0.4%	2.3%	1.1%	1.3%
MSCI United Kingdom All Cap Index	-0.8%	8.4%	0.9%	5.9%
MSCI United Kingdom Index	-0.4%	8.9%	0.9%	5.8%
MSCI AC World Index	5.6%	12.8%	7.7%	12.9%
MSCI AC World (ex UK) Index	5.9%	13.0%	8.1%	13.4%
MSCI AC World (ex US) Index	2.0%	5.5%	0.5%	4.7%
US Dow Jones Industrial Average	11.0%	19.4%	12.9%	24.2%
S&P Composite Index	9.0%	19.8%	14.7%	21.3%
MSCI Europe (ex UK) Index	3.0%	6.3%	1.3%	1.3%
Tokyo TOPIX Index	4.5%	7.7%	4.9%	13.0%
MSCI AC Asia Pacific ex Japan Index	-0.2%	2.2%	-2.0%	4.9%
MSCI Emerging Markets	0.1%	-2.1%	-4.2%	2.0%
Waverton Growth Index	4.0%	9.3%	5.6%	9.8%
Waverton Growth UK Bias Index	2.6%	8.4%	4.2%	8.3%
Waverton Balanced Index	3.1%	7.3%	4.3%	7.9%
Waverton Balanced UK Bias Index	2.0%	6.6%	3.1%	6.7%
Waverton Cautious Index	2.2%	5.3%	3.0%	6.0%
Waverton Defensive Index	1.6%	3.9%	2.2%	4.6%
Return on Cash £ (1 month deposit rate)	0.2%	0.3%	0.4%	0.5%
Inflation - UK CPI	0.7%	1.5%	1.5%	2.3%
Gold Price (£913.68)	-3.6%	-3.2%	-5.2%	-4.5%
£ vs US$	-1.2%	-7.0%	-3.6%	-2.8%
£ vs Euro	-0.7%	-1.6%	-0.3%	-1.1%
£ vs Yen	1.3%	-0.7%	-2.8%	-1.9%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	-0.7%	-0.6%	-1.8%	-1.7%
Citigroup World Govt Bond Index	-1.6%	-4.9%	-2.5%	-1.5%
MSCI United Kingdom All Cap Index	-2.0%	0.8%	-2.7%	2.9%
MSCI United Kingdom Index	-1.7%	1.2%	-2.7%	2.9%
MSCI AC World Index	4.3%	4.8%	3.8%	9.8%
MSCI AC World (ex UK) Index	4.6%	5.0%	4.2%	10.2%
MSCI AC World (ex US) Index	0.7%	-1.9%	-3.1%	1.8%
US Dow Jones Industrial Average	9.6%	11.0%	8.8%	20.8%
S&P Composite Index	7.7%	11.4%	10.6%	17.9%
MSCI Europe (ex UK) Index	1.8%	-1.1%	-2.4%	-1.5%
Tokyo TOPIX Index	3.2%	0.2%	1.1%	9.8%
MSCI AC Asia Pacific ex Japan Index	-1.4%	-5.0%	-5.5%	2.0%
MSCI Emerging Markets	-1.1%	-9.0%	-7.7%	-0.8%
Waverton Growth Index	3.3%	3.7%	2.8%	7.3%
Waverton Balanced Index	2.7%	3.0%	2.1%	5.8%
Waverton Cautious Index	2.1%	2.3%	1.4%	4.2%
Waverton Defensive Index	1.6%	1.9%	1.2%	3.4%
Return on Cash $ (1 month deposit rate)	0.5%	1.0%	1.4%	1.8%
Inflation - US CPI	0.1%	1.0%	2.3%	2.2%
Gold Price ($1191.49)	-4.8%	-10.0%	-8.6%	-7.2%

* All MSCI benchmarks are net of tax

Source: Factset,Thomson Reuters DataStream

This material is for your private information and should not be distributed further. The views and opinions expressed are the views of Waverton Investment Management Limited and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. We encourage you to consult your tax or financial adviser. All material(s) have been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS AND THE VALUE OF SUCH INVESTMENTS AND THEIR STRATEGIES MAY FALL AS WELL AS RISE. CAPITAL SECURITY IS NOT GUARANTEED.

WAVERTON INVESTMENT MANAGEMENT LIMITED 16 BABMAES STREET LONDON SW1Y 6AH 020 7484 7484 WAVERTON.CO.UK

Registered in England Number 2042285. Authorised and Regulated by the Financial Conduct Authority