London&Capital

# THE FED BLINKS: TIGHTENING POLICY POSTPONED

Global Macro & Market Outlook
Second Quarter 2019

# PARTNERSHIP INVESTMENT CHOICE PRUDENCE

London & Capital's approach to investing is the same as our approach to our clients.

We listen and observe. We ensure we have a complete understanding and then invest accordingly to provide financial stability and investment returns. No hunches, just learning from homework and history.

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# INTRODUCTION

**Pau Morilla-Giner**
Chief Investment Officer

Throughout the past quarter, US Fed Chair Jerome Powell executed the monetary policy equivalent of a screeching handbrake turn.

After suggesting late last year that interest rate hikes and balance sheet reductions were on a pre-set path, Powell has dramatically reversed his course by indicating that the Fed no longer has a tightening bias and that rates would probably stay on hold for the remainder of the year.

Justifying the change, he pointed out that “while the economic baseline remained similar, the risks had shifted”. These included “subdued inflation; economic uncertainty (slower external growth, Brexit, trade wars and US government shutdown); and financial market developments...





...Crucially, on the Fed’s unwinding of trillions of dollars of asset purchases, Powell rowed back from earlier comments that this process was on “autopilot”. In doing so, he acknowledged that ‘quantitative tightening’, as it is known, could stop suddenly if the economy were to deteriorate significantly.

## There are three main implications for the Fed’s actions:

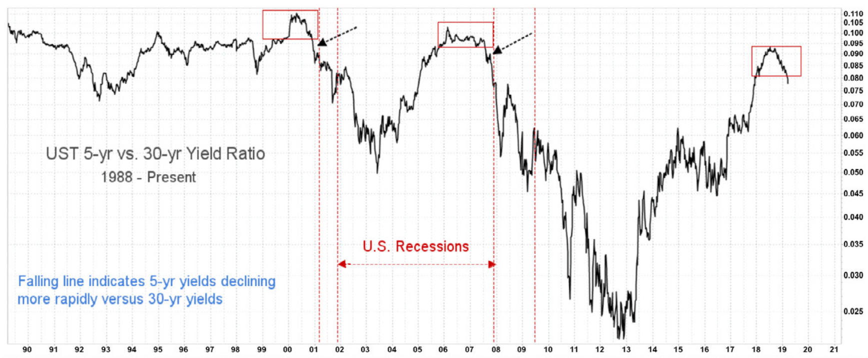
- They postpone recession risk slightly and comfort investors in the short term (good for risk assets in the short term).
- They suggest that the Fed will have very little ammunition to deal with a recession when it happens:
  - It took Alan Greenspan and Bernanke’s FOMC only 2.5 years to raise rates from 1% to 5.25%, which was the lowest cyclical fed funds peak since October 1966.
  - Bernanke’s Fed cut rates ten times, or five whole percentage points, to combat the financial crisis and Great Recession. It also added more than $3.5 trillion to the balance sheet.
- They confirm that slowing global economic growth is forcing central banks to shift policy. This is the most relevant aspect of the Fed’s u-turn.

**Indeed, the plunge in global bond yields and other market indicators suggests a continued rapid slowdown in the global economy.**

Indeed, the plunge in global bond yields and other market indicators suggests a continued rapid slowdown in global economic activity.

In the USA, the difference between the yield on three-month and ten-year US Treasuries turned negative for the first time since August 2007. All but one of the previous “inversions” in this part of the Treasury yield curve, during the post-Bretton Woods era, were followed by a US recession.

**UST 5 years. 30 year yield ratio, 1988-present**




Source: Factset

In Europe, the ECB was confronted with slowing economic growth, uncertain politics and wobbly markets, and so it reliably came to the rescue with new stimulus measures and a deferral of the start to any normalisation of interest rates.

Over the past two years the eurozone economy has left its “normal” growth path following the global financial crisis and has dipped into “Japanification territory”.

A low-growth, low-inflation environment, along with a negative deposit rate and ample central bank liquidity, which bears a striking resemblance to post-bubble Japan for the past quarter century.



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# KEY MACRO RISKS

## These are what we perceive to be the main risks:

- **US economy on track to lose steam**

While US economy was in a sweet spot last year (record high profit margins and fiscal boost), the risks of a significant slow-down and a potential recession in 2020 are increasing as the economy is likely to face a number of hurdles

- the end of the fiscal impulse.
- the impact of the trade war.
- higher interest rates.
- a more cautious financial backdrop.
- a general global economic slow-down.

The economic expansion that began following the depths of the crisis in 2008 and 2009 is at a very mature stage. If we don’t see a recession by mid-year, the current “boom” will be the longest in US history.

**The risks of a significant slow-down and a potential recession in 2020 are increasing as the economy is likely to face a number of hurdles**

## Rise in corporate debt

A significant strengthening in financial capital adequacy (which means banks are stronger than they have been in many years) masks a rise in other corporate debt. US corporate debt jumped to $9.2 trillion from less than $5 trillion in ten years, far outpacing economic top-line growth. Corporate debt is now as large as mortgage-related debt. More problematic, the quality of today's higher debt balances is worse. Debt-to-EBITDA ratios are the highest they have been in years, approaching 2.5 times, up from 1.25 times as recently as 2007. The climb since 2007 has been steady.

## Italy

An increase in market-unfriendly headlines could result in more market turbulence, undermining investor confidence in the Eurozone.

## Brexit

Ultimately, an orderly compromise on Brexit should be reached, although likely at the last moment. However, as the deadline to reach a deal shifts, concerns will likely build that a no-deal outcome — and associated UK and EU market turbulence — could become a reality.

## Global trade

While EU/US trade discussions appear to be amicable at present, a shift would likely impact financial markets. As for US/China trade talks, an escalation of global trade tensions in the coming quarters would likely have a direct impact on economic activity, potentially leading to heightened uncertainty and market volatility.





# ASSET CLASS ALLOCATION

### London & Capital uses a proprietary system to develop forward-looking views across assets:

- Our MACRO monitor is flashing AMBER, as weaker US cyclical growth combines with subdued readings in other Developed Markets. There is a risk that the monitor turns to RED by late next year, as the higher cost of capital makes a dent on consumers and US corporates are forced to refinance at much higher rates.
- Our FISCAL POLICY monitor is flashing AMBER as the impact of tax reform dies down in the US. Despite the spread of populism, Public Debt to GDP ratios are at high levels across the board, which will reduce governments' ability to provide further stimulus in the next recession.
- Our MONETARY POLICY monitor is flashing AMBER and could be turning GREEN again: US Fed is backing down on their measured tightening stance, and other major Central Banks continue with accommodative policies.
- EARNINGS monitor flashing AMBER and in danger of turning RED as embedded expectations of global corporate earnings remain quite optimistic. Corporate profit margins are at record highs, so there is scope for disappointment on that front.
- VALUATION monitor has been in RED for a few quarters now: after years of financial repression, few listed assets are below historical averages.
- SENTIMENT monitor is in AMBER: there is still plenty of cash on the sidelines (a bullish indicator), but the start of the year rally is bound to lose momentum.

**On the back of the monitors, our current Asset Allocation views can be summarised in the following way:**

**CASH - Overweight**

- Geopolitical uncertainties and profit taking merit overweight in our Cash and Cash Plus strategies.
- Short maturity, high quality bonds attractive.

**FIXED INCOME - Neutral**

- Reduction in non-financial corporate High Yield allocation, in favour of Investment Grade, Cash Plus and Alternative Income.
- Core exposure to the Financial Bond space remains.

**EQUITIES – Underweight**

- We have maintained a bias towards US equities, but reduced it in favour of Europe and emerging market equities. We believe high quality equities are well positioned to capture returns in the last innings of the bull market, while being resilient on the way down.

**ALTERNATIVES – Neutral to Overweight**

- Truly uncorrelated alternative strategies will continue to complement the rest of the portfolio.
- Important to avoid leverage and illiquidity.







# DEVELOPED MARKETS OUTLOOK

## US ECONOMIC OUTLOOK

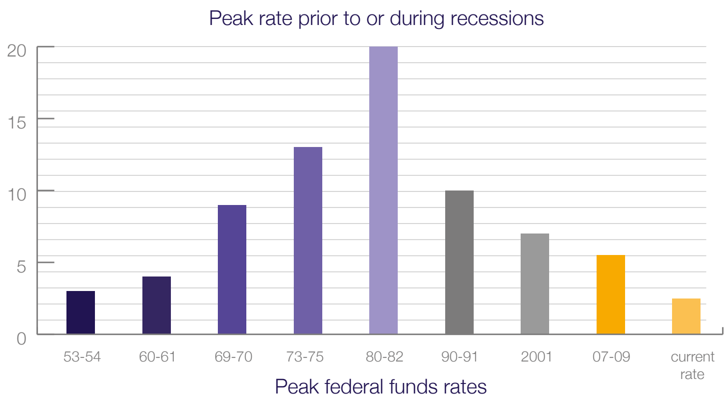
- **Slower economic growth triggers monetary policy reset.**
- **A dovish Fed removes rate hikes and resets for balance sheet expansion.**
- **Recession risks continue to rise for 2020.**

Slower growth, lower inflation and a significant fall across asset markets made the Federal Reserve blink at the start of the year. Then at the March FOMC meeting, it dramatically took all rate hikes off the table and signalled an early end to balance sheet reduction. As part of its monetary strategy, the balance sheet is set to rise in the medium term with a shift towards buying Treasuries whilst mortgage-backed securities will be run off with reinvestment into Treasuries. This shift has already had a significant impact across global interest rates as government bond markets have rallied, reducing the cost of funding markedly.

The burning question is what has the Fed seen that has triggered this change of heart? We believe that there are two additional factors at play (apart from lower growth and inflation). First, the Central Bank seems to have taken fright at the drying up of liquidity at the end of last year, which triggered sharp declines in risk markets and a significant rise in credit spreads, threatening the global economy. Second, the Fed is also likely to view the spate of deleveraging by companies (e.g. GE, GM, Ford, AT&T, Caterpillar and Anheuser Busch) as a major threat to economic growth as it coincides with the US economy slowing naturally (after almost a decade of expansion). This deleveraging simply means that companies are more likely to cut back on capital expenditure and may eventually start laying off workers as well. This toxic mix would threaten a recession rather than just a mild economic slow-down.

As a result, the FOMC has signalled that the Fed Funds rate is set to peak at the lowest rate ever in a tightening phase. Oxford Economic Forecasting's (OEF) analysis shows that the average peak in rates was just over 9% since the early 1950s, compared to the current average Fed Funds rate of 2.4%. The chart also highlights the fact that the terminal (i.e. end Fed Fund rate at the onset of a recession) rate has been trending ever lower over the past three decades as inflation and economic growth rates have trended lower.

**Lower peak Federal Funds rate**




Source: OEF

## What has the Fed seen that has triggered this change of heart?

**At this stage, the underlying data does not point to an elevated risk of a contraction this year. But as we stated last quarter, the risks of a significant slow-down and a potential recession in 2020 are clearly increasing as the economy is likely to face a number of hurdles:**

- the end of the fiscal impulse.
- the impact of the trade war.
- the cumulative impact of the rise in interest rates seen in 2018.
- a difficult financial backdrop.
- a general global economic slow-down.

Despite the momentum we saw in 2018, economic growth is set to slow to a more sustainable 1.75-2.25% range (a downgrade from last quarter).

At this stage, the underlying data does not point to an elevated risk of a contraction this year.

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# CANADA ECONOMIC OUTLOOK

- Growth downgrade continues to c. 1%
- Bank of Canada becomes dovish: Monetary policy set to become looser

It is clear that Canada has not been spared the global economic and market forces at play. To some extent it is buffeted more than most of the G7 economies by fluctuations in energy prices and trade conflicts. Not surprisingly economic growth is likely to slow further this year to c. 1.0% (a 0.5% downgrade since late 2018). This follows the Bank of Canada (BoC) lowering both actual and potential output growth estimates by up to 0.5% over the next two years. At just 1% growth, clearly the risk of a recession is now far greater, triggering a far more dovish monetary stance. At its March meeting, the BoC unsurprisingly kept the key overnight interest rate steady at 1.75% and acknowledged "the slowdown in the global economy has been more pronounced and widespread than the Bank had forecast in its January Monetary Policy Report". It has decided to keep rates below the neutral rate as it examines the depth of the slow-down and its implication for inflation. We would judge the likelihood of a rate cut by the BoC to be far greater than in the US at this time.

**A key area of concern is consumers. As spending continues to ease from the post-2015 strength, most underlying forces are likely to provide further restraint going forward:**

- slower real disposable income growth.
- less exuberant labour market.
- a slower housing market.
- the constraining impact of macro-prudential measures.

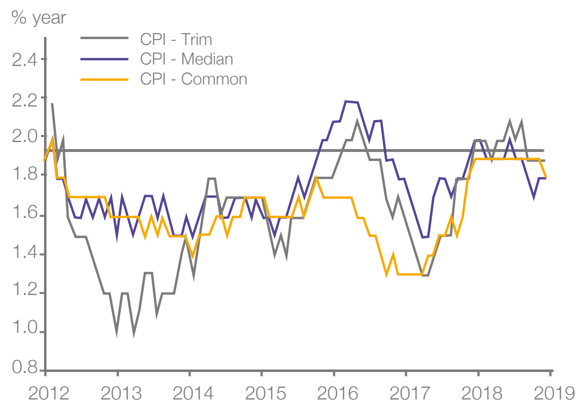
**Lyn Paterson (Deputy Governor of the BoC) implied in a speech that the slow-down in spending is being monitored closely and highlighted the following as key drivers of consumer spending that the Central Bank is monitoring:**

- lower spending on cars & vacations.
- a slower housing market (sales).
- a decline in mortgage and consumer borrowing.

It is unlikely that there will be an improvement in any of these underlying forces any time soon. The BoC is set to update growth projections at the April meeting and is likely to downgrade projections, even further setting the scene for a rate cut.

The pressure for a shift in policy is also likely to intensify if inflationary pressures continue to ease. Even though headline inflation edged higher to 1.5% in February, this uptick in the annual rate was largely due to higher mortgage costs (not a factor going forward) and a sharp pick-up in seasonal food production (unlikely to be maintained). The BoC's key core inflation rate is running below the 2% target and its three preferred measure of core inflation (trim, median and common) have all settled below 2%.

**Bank of Canada Core CPI measures heading lower**




Source: OEF:

# EUROPEAN ECONOMIC OUTLOOK

- Significant economic slow-down forces the ECB into a dovish twist.
- Risk of recession continues to rise.
- Sentiment continues to be buffeted by politics and external factors.

European growth has continued to disappoint, with momentum slowing and further downward revisions to consensus projections. The ECB stated in its latest Economic Bulletin, "The weakening in economic data points to a sizeable moderation in the pace of the economic expansion that will extend into the current year… Moreover, underlying inflation continues to be muted. The weaker economic momentum is slowing the adjustment of inflation towards the Governing Council's aim". The question is why it took the ECB so long to acknowledge the slow-down that was plain to see.

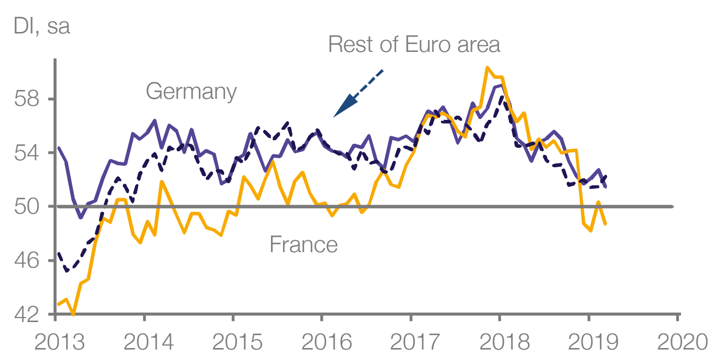
Nevertheless, the ECB announced significant changes to its monetary stance which could be labelled as "waving a white flag". First, the key interest rate will be held at the current rate (i.e. negative) throughout this year, with a clear implication that it could be held at this level for even longer. Second, it will continue to reinvest, in full, all redeeming securities for a prolonged period (i.e. no end in sight) and well beyond the time when rates are increased (note that the threat of this has already disappeared). Third, the ECB will launch a new series of quarterly targeted long-term refinancing operations (TLTRO) from September 2019 through to March 2021. Finally, it will continue to conduct lending operations as fixed-rate tender procedures with full allotment at least through to March 2021. The aim is clear - continue to provide significant liquidity to prevent a recession and a further decline in inflationary pressures. Thankfully, the European banking system is in a much stronger position than during previous periods of uncertainty.





Underlying this shift in monetary policy is the rising risk of a recession across the Eurozone. Germany only just avoided a recession in the second half of 2018 as it was buffeted by trade tensions and the diesel impact on the auto sector. It is clearly critical for prospects to stabilise in the Eurozone's largest economy. Overall Eurozone GDP growth this year is likely to ease to just 1.0%, with risks to the downside. A number of weaker economies, in particular Italy, Spain, France and Greece, are most vulnerable to a hard landing. The most recent survey data (PMI for March) showed a significant drop in manufacturing confidence with contraction similar to the downturn in 2012. Germany and France in particular showed significant weakness.

**Purchasing Managers Index (PMI): Sagging confidence**




Source: JP Morgan

**European growth has continued to disappoint, with momentum slowing and further downward revisions to consensus projections.**

**Domestic consumption in particular has been rather weak, despite plenty of supportive factors such as:**

- Relatively strong job creation.
- Buoyant employment expectations.
- Upward momentum in nominal and real wages (real income growth likely to be at its fastest since 2006).
- A pick-up in consumer loans from regional banks.

If these forces come to the fore, the Eurozone may yet avoid a recession.

Capital investment also lost steam in the final quarter of 2018, most likely reflecting heightened political and financial volatility. This offset the impact of low borrowing costs and greater liquidity. The ECB's liquidity measures should provide support, but of course capex will only rise if demand conditions are supportive and the background volatility (be it Brexit, China, tariff threats) recedes. Finally, fiscal policy should provide a more positive backdrop after years of austerity. The overall fiscal impulse is expected to be in the region of 0.3-0.5% of GDP, representing the largest loosening since 2010.





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# UK ECONOMIC OUTLOOK

- **The economy has slowed as Brexit uncertainty dominates.**
- **Fiscal dividend in the event of an orderly exit.**
- **Monetary policy on prolonged hold but Brexit outcome could sway rate policy.**

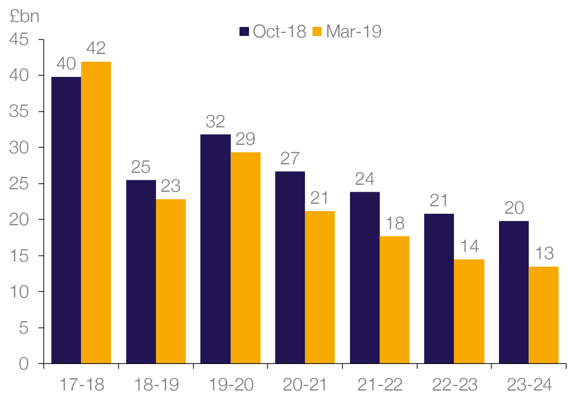
**The outlook remains for subdued growth, it is difficult to see a significant short term upside boost even with a more conciliatory outcome, due to the global economic slow-down.**

There continues to be immense uncertainty over the likely Brexit outcome as the cliff-edge of a hard Brexit has been postponed. There seems to be a growing sense that a hard Brexit outcome is now less likely given moves in Parliament. However, the situation is incredibly fluid. The potential political scenario includes PM May stepping down and a new leader in place, a move to delaying Brexit for the long term or a general election. In the meantime, the economy continues to splutter and we are left to make judgements on the path for monetary policy – and ultimately financial assets. The outlook remains for subdued growth, and it is difficult to see a significant upside boost in the short term in the event of a more conciliatory outcome, purely due to the global economic slow-down. However, the Bank of England will remain a reassuring presence in terms of keeping policy stable and continuing to provide liquidity to the key financial sectors if needed in the event of an adverse outcome.

It is certainly true that the economy has not gone into recession; since our last update it has performed slightly ahead of expectations, particularly in the case of consumer demand.  On the other hand, last year ended with mixed retail data and the British Retail Consortium highlighting the worst outcome for a decade during Christmas. However, there was an unexpected rebound as retail sales jumped by 0.9% in January and recorded a decent 0.4% rise in February as well, with the annual rate at 4%. Clearly it would seem that the low unemployment rate and higher real disposable income continue to be supportive.

In contrast, sentiments remain weak in both services and manufacturing; in fact it is at some of its lowest levels since 2010. The economy also continues to be hampered by weak capital investment and the fading positive contribution from net exports.

**Fiscal Dividend from Lower Budget Deficits**




Source: OEF







Investment has continued to slow, having been a bright spot over the previous five years. Investment intentions from the Bank of England, CBI and market surveys are all fairly subdued, with businesses citing uncertainty over future trading relationships as a key concern (despite healthy profits and low borrowing costs). The start of the year has brought no cheer from the auto sector (admittedly not all due to Brexit concerns). The positive contribution from net trade has also faded rapidly due to a bounce in the currency and lower world trade growth.

Fiscal policy was already loosened late last year due to significant generous revisions to borrowing projections by the OBR. This led to a large uplift in NHS spending and a generous rise to tax thresholds as well. This should provide a small positive boost to the economy in contrast to the previous projection of a drag of almost 0.5%. However, due to further growth and public-sector revisions, the Chancellor was able to indicate that there may be a further fiscal dividend of up to £30 billion that could be used to boost the economy in the event of an orderly Brexit outcome. One suspects that fiscal policy will be used whatever the outcome.

**The economy has certainly not gone into recession; since our last update it has performed in line with expectations**





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# EMERGING MARKETS OUTLOOK

- **EM contagion fears less pronounced, but growth has weakened.**
- **Chinese growth will be lower due to domestic and external considerations.**
- **Indian growth holding up with fiscal and monetary support.**

Emerging Markets (EM) assets have recovered somewhat from the battering they took in 2018 as they confronted a perfect storm of rising US interest rates, a shrinking Fed balance sheet, a stronger US dollar, weakening commodity prices, trade conflicts and a volatile political landscape. In addition to these external factors, there was undoubtedly a more challenging domestic environment in a number of countries. It all translated into a weaker growth profile coupled with significant adverse currency moves and a rolling crisis with Brazil, Argentina and Turkey in particular in the spotlight through the year. As with most developed countries there were negative economic surprises almost across the board. Although EM growth was still ahead of Developed Markets (DM), this differential narrowed significantly. Looking ahead, many of the challenges will persist but there may well be positive growth surprises in some countries.

## Portfolio positioning in EM assets and economic analysis is driven by an examination of key sovereign risk indicators such as:

- reliance on external debt
- FDI (Foreign Direct Investment) flows
- government deficits and debt levels
- importance of external sector verses domestic growth
- the possibility of policy support.

This analysis suggests that widespread economic contagion is unlikely, but investors remain wary of financial asset price movements outweighing underlying economic strength in a number of countries.

## China:

**The loss of growth momentum in China has undoubtedly been one of the key contributing factors to the global economic slow-down. The lower growth projection (at 6-6.5%) was officially confirmed by the 2019 Government Work Report (GWR), which also held out the prospect of further fiscal support and loose monetary policy. However, it also acknowledged that the macro leverage is likely to be kept "basically stable", i.e. that they have a delicate act in wanting to boost credit but not overdo the imbalance. Some of the key measures within the GWR include:**

- changes to real estate taxation.
- infrastructure investment increase.
- measures to boost foreign direct investment.

**However, it also acknowledged that the macro leverage is likely to be kept "basically stable", i.e. that they have a delicate act in wanting to boost credit but not overdo the imbalance.**

This implies that there will be some further tax support and reform but the state sector pump-priming is unlikely to be repeated unless absolutely necessary. Nevertheless, the budget deficit is set to rise to over 6% this year (from 4.7% in 2018) as tax cuts come through.

Consumption held up well in the first quarter of the year as the authorities had already implemented a whole string of fiscal initiatives including personal tax changes (a move to itemised deductions), sales tax and tariff cuts to boost auto sales, infrastructure measures and direct intervention in housing and land purchases. On the monetary front, the People's Bank of China (PBoC) has cut banks' reserve requirement ratios and is likely to deliver further cuts in coming quarters. In addition, it is also likely to actively use targeted medium-term lending to ensure that there is sufficient liquidity for companies and households. These measures should help in keeping GDP growth close to 6.0%. A more favourable trade outcome could boost growth to 6.25%, but it is unlikely to lead to a speedy recovery, particularly as there are natural constraints, with potential output lower.

The trade conflict with the US has sapped economic growth due to the determination of the US to use tariffs to correct its huge trade deficit with China. Even though a temporary truce has been called, there will inevitably be a rebalancing in trade and China will have to give ground in some areas. If the recent positive momentum in bilateral talks is maintained, the fears of an outright trade war may evaporate, but there is unlikely to be an early end to the uncertainty and in the meantime concerns over growth will continue to mount.

## India:

The economy slowed in the second half of the year from the elevated 8% recorded in mid-2018, as monetary tightening had an impact as did the clamp down on non-financial sector lending practices. Although this latter measure was overdue given the significant build up in liquidity from this largely unregulated sector (and the resultant build-up in non-performing loans) it has now been eased under significant pressure from the government and companies. The change in leadership at the Central Bank has led to a shift in policy, with a more government-friendly dovish stance emerging. The Reserve Bank of India (RBI) took advantage of lower inflation and economic activity to trim the key interest rate by 0.25% to 6.25% in February. It has hinted that further monetary loosening is on the cards. The new RBI Governor has also eased the restrictions on public sector banks and has allowed significant liquidity injection by the government.

The political landscape has also become more challenging ahead of the general election (over a 7-week period beginning in April) with P.M. Modi likely to face a stiffer challenge from the Congress Party. He may still re-emerge with a majority but certainly not with the runaway victory he got last time round. Some polls point to a hung parliament, which will hamper policy-making at a critical time.

The economic growth projection for 2019 has been kept steady at 7%, despite the global economic slow-down, largely due to looser domestic monetary and fiscal policies.

**The economic growth projection for 2019 has been kept steady at 7%, despite the global economic slow-down, largely due to looser domestic monetary and fiscal policies.**

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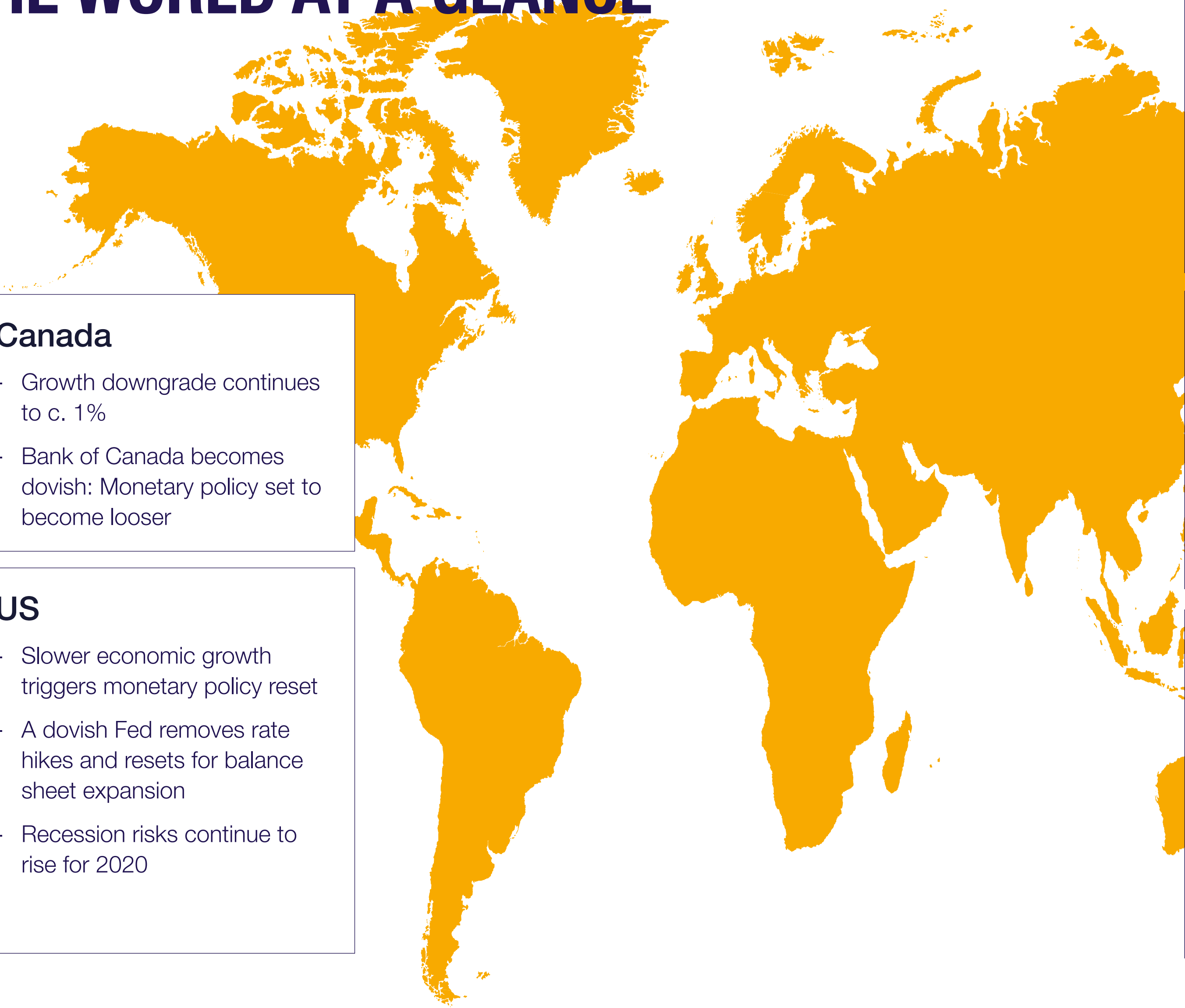
# THE WORLD AT A GLANCE



## Canada

- Growth downgrade continues to c. 1%
- Bank of Canada becomes dovish: Monetary policy set to become looser

## US

- Slower economic growth triggers monetary policy reset
- A dovish Fed removes rate hikes and resets for balance sheet expansion
- Recession risks continue to rise for 2020

## UK

- The economy has slowed as Brexit uncertainty dominates
- Fiscal dividend in the event of an orderly exit
- Monetary policy on prolonged hold but Brexit outcome could sway rate policy

## Eurozone

- Significant economic slow-down forces the ECB into a dovish twist
- Risk of recession continues to rise
- Sentiment continues to be buffeted by politics and external factors

## Emerging Markets

- EM contagion fears less pronounced, but growth has weakened
- Chinese growth will be lower due to domestic and external considerations
- Indian growth holding up with fiscal and monetary support

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# FIXED INCOME

# GOVERNMENT BONDS:

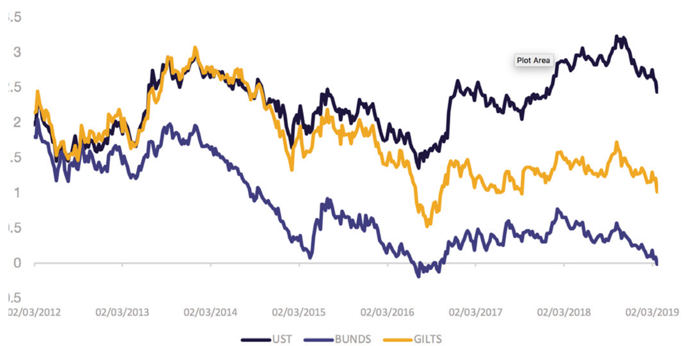
- We have raised duration through the past six months
- We have also increased investments in Government bonds throughout the first quarter
- Higher duration is likely to remain in place for the next quarter

**In such an environment, it would be reasonable to expect yields to fall further across major markets and they may well test historic lows.**

London & Capital Asset Management (LCAM) portfolio duration has gradually been raised over the past 6-months as evidence of slower economic growth mounted. This was inevitably going to lead to a change in monetary policy expectations. However, the speed of change in tone by the US Fed and the ECB has provided a significant boost to government bonds. Benchmark 10-year bond yields have plummeted across the board; US 10-year Treasuries are testing 2.4%, German Bunds are in negative territory and UK Gilts are approaching 1%. Of course, a change in monetary stance is only relevant if it is in response to lower growth and inflation. In this case, it is. However, there is also a suspicion that Central Banks may have been a bit too sluggish in their response given the weakness of underlying economic data.

How low could yields go? Clearly we do not face the financial crisis that haunted policy-makers post 2008. Looking at the economic and policy backdrop, it would seem as if the recipe is there for a further significant drop in yields, as the economic challenges are still severe even if banks are not facing the threat they did back in 2008-2010. In essence, the firepower available to Central Banks to avoid a significant economic downturn is rather limited given that interest rates are still exceptionally low and asset purchase programmes are still in place in various guises. The political dimension adds to the problems, with division apparent in most economies and across major trading blocs. Low productivity and low unemployment rates exacerbate the problem and further limit policy choices. In such an environment, it would be reasonable to expect yields to fall further across major markets and they may well test historic lows particularly in Europe.

**10-year yields trending lower**




Source: Bloomberg

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# CORPORATE INVESTMENT GRADE

- **We have improved the credit quality of LCAM portfolios over the past six months**
- **Portfolios have continued to move up the credit curve**
- **Selective exposure to BBB-rated bonds**

## Rationale for overweight:

**The primary reason for overweight holding in high quality corporate bonds is that lower government bond yields will drive corporate bond yields down too (meaning bond prices will rise). Additional factors for the focus on higher grade corporate bonds (A-AA) include:**

- Slowing growth (with rising probability of a recession).
- Reasonable corporate leverage & interest cover.
- Good cash flow.
- High cash balances.
- Relatively low refinancing risks.

Despite fears of rising corporate leverage and potential refinancing risks, it is important to stress that higher rated companies have generally been actively prolonging the maturity of their outstanding debt. The net supply of corporate bonds is set to fall by almost a third in 2019.

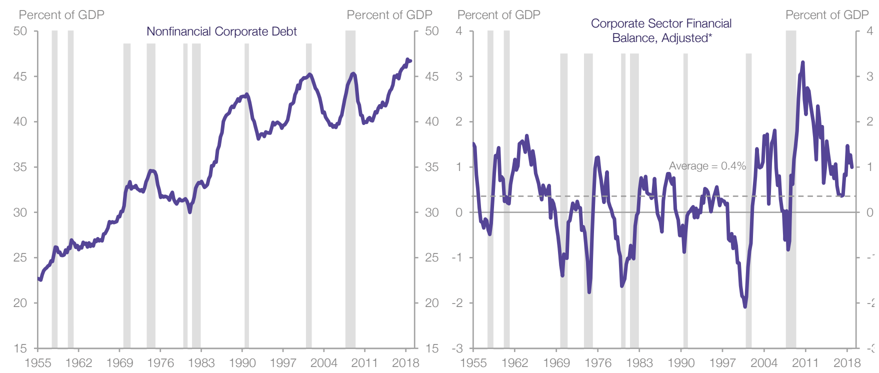
**We retain our bias towards higher grade corporates with a focus on strong cash flow companies.**





There has been a great deal of concern over the growth of the corporate debt market post-financial crash as companies took advantage of low rates and as a substitute for the lack of funding from banks. As a result, corporate debt has increased to c. 48% of GDP, well above previous peaks. Recent analysis by Goldman Sachs neatly summarises the situation, focusing on the fact that the corporate sector financial balance (gap between income and spending) is in positive territory and above historic averages. This does not mean that all is rosy for corporate debt; lower rates/ yields are a positive but a slower economy and lower earnings will still be a threat. Taking into account various factors, we retain our bias towards higher grade corporates with a focus on strong cash flow companies including regulated industries.

**Trends in non-financial US corporate debt**




*Defined as net income + depreciation - capital expenditures - dividends for the nonfinancial corporate sector, where capital expenditures include fixed investment but exclude inventory investment and inter-sector M&A. We adjust the financial balance due to the impact of TCJA on transfers in 2017Q4.

Source: Goldman Sachs

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We are also selectively buying BBB-rated bonds in your portfolio, as a number of global companies undertake significant deleveraging to climb back up the rating scale. Over the past few months we have seen companies such as GE, AT&T, GM, Ford, Verizon and Caterpillar all beginning to deleverage significantly. As examples, GE is well on its way to reducing leverage (Net Debt/EBITDA) from c.4x to 2.5x, AT&T is also moving in a similar direction. This deleveraging is also coinciding with a lengthening in maturities. This provides opportunities to lock-in yield levels that imply a credit downgrade in some cases. Overall, we are reducing the BBB exposure as it would not be a surprise that some companies suffer credit downgrades given the size of the BBB universe.

## Risks:

The primary risk is an abrupt end to economic expansion, in turn threatening corporate prospects. A damaging rise in credit risk (i.e. a further widening in credit spreads) would be a danger, particularly for the lower end of the investment grade spectrum. These lower rated Investment grade (IG) bonds have faced a more challenging environment and selectivity will be crucial. We are underweight in sectors such as retail, energy and consumer cyclical.

# FINANCIALS LONG-TERM VALUE PLAY - STRATEGIC OVERWEIGHT:

- Strategic overweight to be reduced in Additional Tier 1 (AT1) debt; US prefs and European CoCo bonds

## Rationale for overweight

LCAM strategies have been overweight in bank and insurance bonds since 2010 and we continue to recommend a strategic medium-term holding particularly in subordinated bonds. The focus remains on the G-SIFIs (Global Systemically Important Financial Institutions), national champions and major insurance companies. There has seen a significant bounce back in financial bonds this year as credit spreads have narrowed. However, it is likely that price volatility will be elevated at times.

The detailed LCAM Bank Credit Review (a separate report covering the banking universe within LCAM clients' portfolios) shows that across the board banks have strong balance sheets, significant capital buffers and large liquid asset pools, providing a further buffer against market volatility and diversified funding sources. All of these provide the rationale for the positive slant in your portfolio.

There are a number of specific issues that have arisen, which we will need to monitor closely; money laundering, possibility of non-calls and European banking mergers.

The Estonian money laundering scandal has ensnared almost all Nordic banks, but price reaction has been limited. Danske is at the centre of the storm; there are no holdings in Danske in our clients' portfolios. Other bank exposure is relatively limited and generally in short-dated call bonds. This lack of price reaction partly reflects the strength of their balance sheets and the fact that they have very large buffers in place to pay fines. All of them have also been generating profits and can withstand a short-term hit from penalties imposed by regulators.

There is also an increasing focus on whether banks will call bonds on the first call date and whether there is an extension risk if bonds fail to be called. Santander recently failed to call the Euro bond on time; in the end the price reaction was relatively limited as the bank had been fairly transparent with the Euro bond holders (and it had also raised monies through a new USD AT1 issue at the same time). It became apparent that the non-call made perfect sense from both the investors' and the issuers' perspective. We have now seen a number of banks issuing new AT1 paper as they pre-fund ahead of call dates, particularly Nordea and Barclays. A non-call does not carry the stigma as before, as banks in most cases have excess capital. In addition, call dates do not revert to becoming perpetual but switch to either daily, monthly, quarterly or five years. Therefore, the duration remains constrained.

We may also be entering a new phase of European banking mergers. Deutsche and Commerzbank are in the midst of negotiations (with the blessing of the government and the Bundesbank) to create the third largest pan-European entity with over €1.8 trillion of assets. We believe that the fragmented nature of the European banking industry will inevitably lead to mergers in the coming years as banks attempt to build larger asset and deposit bases.





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## Risks:

The primary risk is a significant stock market correction and a worsening in underlying economic conditions, especially for the higher-beta subordinated universe. However, in our judgement these should not be viewed as akin to 2008 or 2010 but rather a source of more normal price volatility. It is also important to note that AT1 debt legally includes capital triggers and coupon deferral language. We have seen banks remaining highly capitalised within the severe bank stress tests carried out by the regulators, but nonetheless it is important in bear in mind the legal aspects and the fact that prices can drop significantly.

**We believe that the fragmented nature of the European banking industry will inevitably lead to mergers in the coming years as banks attempt to build larger asset and deposit bases.**



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# CORPORATE HIGH YIELD – SELECTIVE AND UNDERWEIGHT:

- **Strategic underweight in US high yield given stretched valuations and risk of M&A activity**
- **Selective exposure in sectors with improving credit metrics**

## Rationale for selective positions:

Generically the high yield sector is still supported by reasonable leverage and interest cover, high cash balances and relatively low refinancing risks. Clearly this does not mean that a scatter gun approach can be taken to allocation; detailed due diligence on sectors and individual credits is crucial.

## Risks:

A further significant correction in stocks and a sharp rise in sovereign bond yields are two key market-related risks. In terms of stocks, a 10-15% correction would be viewed as the norm, i.e. not a bear market correction, and would lead to heightened high yield bond price volatility. This is unlikely to lead to a major shakeout or a shift higher in default rates. The key risk to high yield is a recession (which is not our base case), which would trigger a significant jump in implied and observed default rates.

**Detailed due diligence on sectors and individual credits is crucial**

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# EMERGING MARKET INVESTMENT GRADE AND HIGH YIELD DEBT – SELECTIVE OVERWEIGHT:

- **Selective exposure to India, China and Brazil hard currency debt.**
- **No local currency debt exposure despite the sharp falls in recent months.**

LCAM strategies have benefitted from the selective approach to EM debt with the overweight in India and China. We will maintain this overweight in sovereign, quasi-sovereign and large-cap corporate bonds.

## Rationale for selective overweight:

Internal growth dynamics in China and India look reasonable and credit dynamics are supportive.

## Risks:

An outright trade/currency war is clearly a risk, particularly for the higher beta emerging market economies. However, we believe our selective exposure should shield the portfolio.

**We will maintain this overweight in sovereign, quasi-sovereign and large-cap corporate bonds**

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# EQUITIES
# OVERVIEW

2019 started with a strong recovery for equity markets from the oversold levels of December. Global Equities posted double digit returns as investor sentiment recovered and the Federal Reserve reversed policy away from a tightening bias. Furthermore, progress on trade talks and the fact that the start to 2019 wasn't a disastrous economic outcome aided a recovery in market sentiment.

**The consequence of this re-rating is that equity market valuations, especially in the US, are vulnerable**

Importantly, the rate of economic slowdown has moderated, but it is far from clear that the anticipated second half recovery will materialise. In fact, the most likely outcome is that growth momentum remains at historical lows; that has been the experience since the Financial Crisis, and a strong comparative period from the second half of 2018 makes growth forecasts appear too optimistic.

The direct impact on equity markets is evident in the decline in companies' earnings, with negative growth (a decline) now expected in the first quarter of the year. However, consensus forecasts now predict a stronger second half against a tough comparable base.





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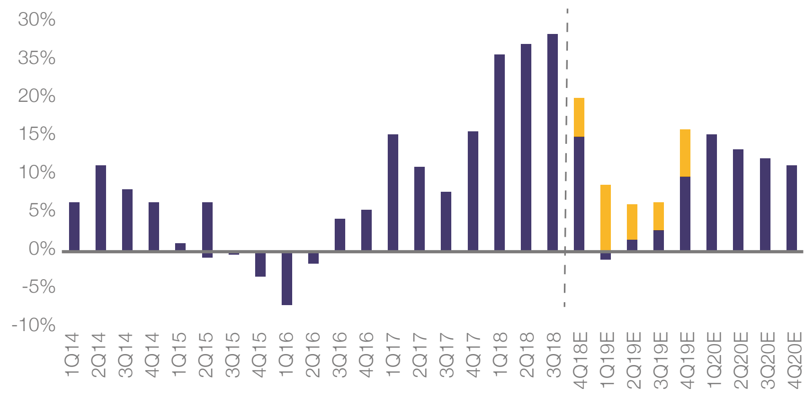
**The chart below portrays this optimism: US equities –earnings**

since the Financial Crisis.



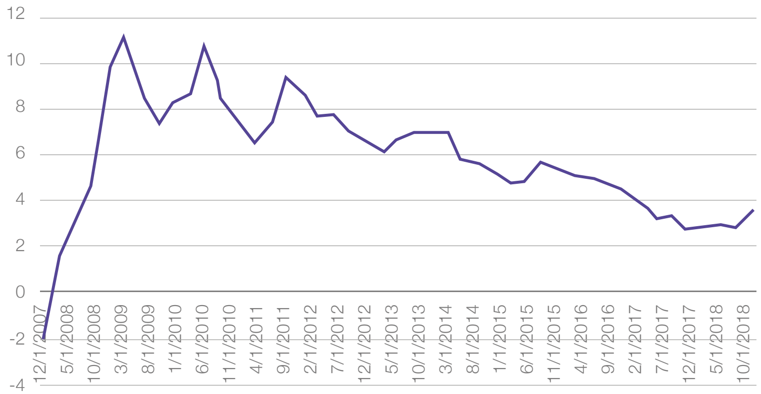

Source: Thomson Reuters, Morgan Stanley Research, as of Feb 8, 2019

The equity market has reacted by moving higher. The consequence of this re-rating is that equity market valuations, especially in the US, are vulnerable, having reached the highest levels on many metrics

**Investing in equities is a lot less compelling than it has been since the end of the financial crisis.**

This chart illustrates the compression of the S&P 500 excess cash returns (Free Cash Flow less the Fed Fund Mid-Rate) in the US

**S&p 500: Equity free cash flow less base rate since the financial crash**




Source: London & Capital, Bloomberg Data

This implies that the enhanced return available for taking more risk and investing in equities is a lot less compelling than it has been since the end of the financial crisis. This suggests that equity investors have become too complacent about the risks of equity investing, or, that the risks themselves have diminished. Given the apparent political risks and debt burdens, it would suggest caution is warranted.

Looking pre-Financial Crisis presents another view, making valuations appear less stretched. However, this period was represented by a very different growth and inflationary outlook. This highlights the unchartered territories that confront equity investors and make future predictions more challenging on the back of historic data analysis.





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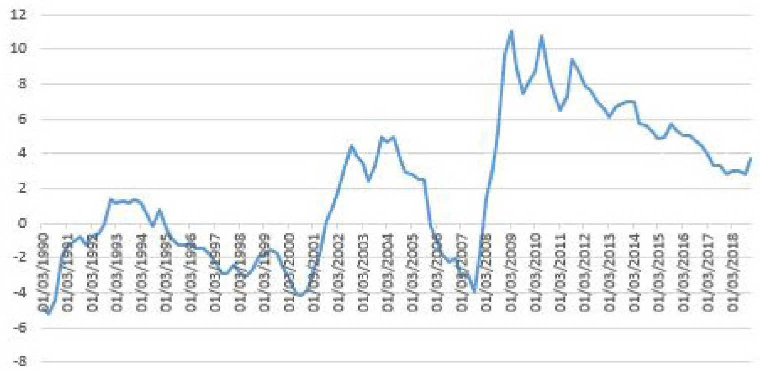
**S&P 500: Equity free cash flow less base rate**




Source: London & Capital, Bloomberg Data

Ultimately, the conclusion is that now is not the time for taking risks, given the vast uncertainties, low confidence and likely anaemic returns.

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# OUR POSITIONING

Our overarching belief in equity investing is that avoiding significant downturns is crucial in maximising longer-term returns. We are applying a cautious positioning, on the basis of elevated risk as the economic cycle approaches its peak, future earnings growth is likely to be muted and equity valuations are extended.

**The track record of our flagship Global STAR equity portfolio has shown consistency in protecting capital in times of market declines.**

This has resulted in a reduction in economic sensitivity in all our clients' portfolios. Furthermore, given the lack of visibility in equity returns for the rest of 2019, we believe our bias to high quality companies is well suited to this environment, providing participation when equity markets rise but also demonstrating much better resilience when markets become stressed.

The track record of our flagship Global STAR equity portfolio has shown consistency in protecting capital in times of market declines:

| Bear Scenarios | Stress Test | STAR | S&P 500 INDEX | Beta on Event |
|---|---|---|---|---|
| Greece May-10 | 31/05/2010 | -5.4 | -8.2 | 0.7 |
| Sovereign Contagion August-10 | 31/08/2010 | 0.4 | -4.7 | -0.1 |
| Eurozone Crisis Aug-11 | 31/08/2011 | -1.7 | -5.7 | 0.3 |
| Chinese Double Dip May-12 | 31/05/2012 | -3.9 | -6.3 | 0.6 |
| Tapering Fears Aug-13 | 31/08/2013 | -2.9 | -3.1 | 0.9 |
| EM FX Sell-off Jan 14 | 31/01/2014 | -2.7 | -3.6 | 0.8 |
| Bear Market Fears Sep 14 | 30/09/2014 | 0.1 | -1.6 | 0.0 |
| China Wake Up Call Aug 15 | 31/08/2015 | -6.1 | -6.3 | 1.0 |
| January Collapse 2016 | 31/01/2016 | -0.7 | -5.1 | 0.1 |
| Interest Rate and Growth Concerns 2018 (1/10 - 31/12) | 31/12/2018 | -8.2 | -12.5 | 0.7 |
| | | | AVERAGE | 0.50 |
| | | | MEDIAN | 0.63 |

Source: London & Capital, Bloomberg Data

Our equity thematic focus is also centred on defensive income, which is very attractive in a low yield environment. Additionally, we see the attraction in Gold stocks as the likely peak in the interest rate cycle should produce a good period return for gold.

# ALTERNATIVES OVERVIEW

The first quarter of 2019 provided some much needed relief for the hedge fund industry as the strong bounce in risk markets led to decent positive returns across most strategies. Having said that, prior deleveraging among fundamental discretionary strategies and risk-off positioning introduced by systematic strategies in the last quarter of 2018 meant that the extent of the participation by hedge funds was limited versus prior rallies. We view it as a positive that hedge funds are running with less beta and will therefore provide more 'hedged' exposure for investors i.e. doing their job in times of uncertainty. The flip side is that hedge funds will continue to underperform should markets continue to soar. According to the HFRX Index, hedge funds gained circa 3% over the quarter.

At the strategy level, in a reversal of Q4 2018, directional equity long-short funds were the best performing over the quarter, with growth-biased strategies in particular performing well. Equity Market-Neutral strategies failed to generate any meaningful alpha, ending slightly negative over the period. In the Event-Driven space, Credit and Distressed strategies were the best performing, while Merger Arbitrage was negative according to HFRX, mainly driven by the deal break between Husky Energy and Meg energy as well as some spread widening in the pharma sector. Among Relative Value strategies, arbitrage and multi-strategy funds performed well. Macro and commodity-trading funds were modestly positive over the period as long exposure to gold and government bonds provided some good trends to follow.



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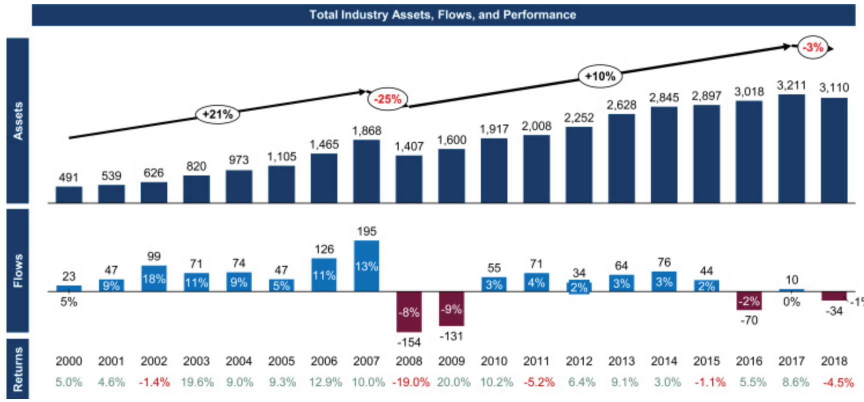
Industry assets continued to consolidate according to data from HFR, driven by a combination of negative performance as well as flows. Clearly there has been some disappointment from investors, but this is also a sign of a maturing industry where the majority of new allocations from institutional investors have now been made, and as of today it's about finessing exposures and rotation across strategy preferences. As we edge further towards the end of the cycle, we do expect to see a stronger investor trend towards truly uncorrelated strategies as market participants look to insulate their portfolios against further market volatility.

**Total industry assets, flows and performance**

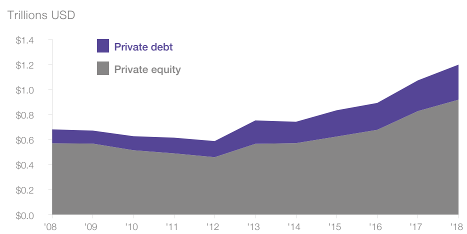



Source: Barclays, HFR

Despite a slowdown in flows in the last quarter of 2018, broader Alternatives allocations remain robust, with Private Equity and Private Debt still garnering lots of attention from long-term investors. However, as valuations get richer and opportunities sparser, dry powder continues to build up and wait on the sidelines.

**Global private credit & equity fundraising**


**Global private capital dry powder**




Source: Preqin, Pitchbook, J.P. Morgan Asset Management. Data are as of December 31, 2018.

**As we edge further towards the end of the cycle, we do expect to see a stronger investor trend towards truly uncorrelated strategies.**







# OUR POSITIONING

Our overall philosophy is unchanged: we continue to believe in a highly-selective approach among upper quartile hedge fund managers with a strong, long-term track record of alpha generation.

London & Capital hedge funds are positioned to be uncorrelated to markets. After strong outperformance at the end of 2018, several funds that were positioned for risk-off suffered. We have moderated the negative bias going forward by taking a more balanced approach for the next few months. The existing set of managers tend to have a variable net exposure, with the ability to add risk if they feel global slowdown fears have become overdone. However, we still feel confident we can deliver meaningful value for clients into any further market volatility.

- Equity long-short: We continue to focus on style-specific (small cap, growth and thematic) and sector-specific (financials, technology) strategies in equity hedge funds. Elevated volatility across the market is providing strong opportunities for those with specialist knowledge that can take advantage of both long and short opportunities.
- Macro/commodity trading: Macro strategies have the potential to benefit from global macroeconomic policies and the effect these have on rates, fixed income and FX. Medium term commodity-trading strategies are expected to benefit from any extended periods of risk-off sentiment which may re-emerge. We therefore believe these strategies provide a complimentary hedge to traditional asset classes.
- Event-Driven: arbitrage strategies across both hard and soft catalyst event-driven plays are enjoying a rich opportunity set, including some complex situations, which provides for added alpha, as well as volatility, which creates good trading opportunities.
- Relative Value: We continue to like volatility arbitrage and the uncorrelated nature of the strategy, which is highly attractive at this point in the cycle.





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In terms of Alternative Income strategies, we continue to recommend a broad mix of funds and investment trusts which provide steady, high single-digit yields in a relatively uncorrelated manner. We prefer asset-backed strategies across short duration private debt, leasing, and renewable energy as well as exposure to insurance linked securities.

In Private Equity we have introduced a select number of idiosyncratic funds and direct investments involved in disruptive areas such as longevity treatments and other areas of biotech, as well as a digital freelancing and credit-scoring platform. We prefer this over a scattergun approach when valuations are high across the industry.

**We continue to believe in a highly-selective approach among upper quartile hedge fund managers with a strong, long-term track record of alpha generation.**





# FX

In our outlook for the first quarter of 2019 we outlined the prospect of US Dollar weakness this year. What we have seen so far is Dollar momentum fading and a largely unchanged trade-weighted US Dollar index year-to-date. US growth and monetary policy differentials which lifted the USD higher in 2018 have peaked, and look increasingly challenged – despite a corresponding slowdown in growth and increase in central bank dovishness globally.

Throughout the first quarter of the year, US data disappointed, with business surveys pointing towards a softer economic environment. After recording growth of 2.6% in the final quarter of 2018, forecasts for first quarter US growth are currently tracking c. 1.5%. Against a backdrop of domestic and external growth deceleration, contained inflation, trade policy uncertainty and financial market volatility, the US Fed has delivered a dovish surprise and performed an abrupt policy U-turn. As recently as last October, Fed officials projected three rate hikes in 2019 and ongoing balance sheet reduction, but following the March FOMC meeting, no rate hikes are now expected and the Fed plans to conclude balance sheet reduction in September 2019.

In both the UK and Eurozone, growth forecasts have also been revised lower, but the potential for economic data to disappoint further is arguably greater in the US, given the already low UK and Eurozone expectations. This backdrop will not necessarily translate into immediate US Dollar declines, because, although it is narrower, the US still enjoys a growth and yield advantage, but the conditions are increasingly favourable.

The outlook for Sterling remains highly conditional on the outcome of Brexit negotiations, but during the first quarter a choppy upward trend has developed versus both the US Dollar and Euro and we expect this to continue. The move higher has been largely due to the manoeuvres and votes in Parliament which have established a consensus against leaving the

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EU without a deal, which in turn have reduced expectations of a disorderly exit, negative shock to the economy and renewed currency weakness. We should expect further Sterling volatility in parallel with the unfolding of the Brexit drama; the twists and turns are not over yet! Under the base case of an orderly exit, Sterling would benefit from a relief rally, but following this there is also potential support from upside economic and policy surprise. Brexit relief could lead to a rebound in both consumer and business sentiment/ spending; beyond this, international investors who have shunned UK assets for some time could be tempted back by greater certainty and attractive relative valuations. On the monetary policy front, it has been noticeable that the Bank of England has not joined the chorus of outright dovishness from global central banks and they have maintained their tightening bias, suggesting they may consider rate increases if the Brexit transition is smooth. Although the Euro would share some of the short-term Brexit relief, the prospects of supportive fundamental and monetary policy conditions look far slimmer.

With US Dollar tailwinds fading and Brexit potentially delivering more upside for Sterling, we have taken steps to minimise unhedged USD exposure for UK clients, having run with a small amount of USD risk in 2018.

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## About London & Capital

London & Capital is an independently owned wealth management company, providing private and institutional investors from across the globe with expert offshore and onshore investment strategies.

We are headquartered in London with a presence in Barbados and are regulated by the FCA (UK), the SEC (US).

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