London&Capital

IT'S COLD WITHOUT THE QE BLANKET

Global Macro & Market Outlook
First Quarter 2019

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INVESTMENT CHOICE
PRUDENCE

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INTRODUCTION

Pau Morilla-Giner
Chief Investment Officer

What a year 2018 has been: US GDP growth hit 4%, Global Earnings Per Share (EPS) rose to all-time highs, US taxes were cut by $1.5tn, US corporates bought $0.8tn of stock, unemployment fell to multidecade lows in the US, UK, Europe, Japan…

And yet…

Cash outperformed stocks & bonds for the first time since 1992. Losses in both US Treasuries and US Investment Grade (IG) bonds were the third largest since 1970, Emerging Market (EM) Credit spreads widened significantly, Global equities were down more than 20% peak-to-trough, and total returns from US Treasuries, high-yield (HY) and IG debt alongside equities, and commodities, were all negative in 2018 (for the first time since 2008!).

Equity drawdowns in 2018 have been remarkable for their extent, the frequency of consecutive negative days, and the synchronised decline in all the major markets. The most common fundamental cause of the severity of equity corrections was an increase in investors' perceptions of downside, or even recessionary, risks to the global economy. Dramatic talk about trade wars obviously exacerbated the drop in confidence.

Despite weaker economic momentum and volatile financial markets, the European Central Bank (ECB) (the central bank which has most distorted asset price valuations since 2012) reiterated its intention to stop using large liquidity injections to support economic activity and asset prices. These signals echo those that the US Federal Reserve (the Fed) has been sending for a while now.

The simple truth is that asset prices and central bank liquidity growth both peaked in the first quarter of 2018…and they have both fallen ever since.

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KEY MACRO RISKS

We are at the stage of the policy tightening cycle where history suggests a higher likelihood of accidents in financial markets: the comfort blanket provided by the largest central bank (i.e. the Fed) is no longer cuddling investors.

US corporate balance sheets are more heavily geared than ever before, but that masks a distinct division between cash-rich companies and a very large rump. The credit quality of the rump has deteriorated since the Great Financial Crisis (GFC) and the covenants of corporate bonds are significantly worse. Overall, large segments of the US corporate sector are increasingly vulnerable to both rising interest rates and ultimately any fall in earnings that might occur during the next recession.

In the wake of the GFC in 2008 and the aftershock of the subsequent Eurozone Debt Crisis (in 2011), central banks around the world started buying their own government bonds on a massive scale.

Buying sovereign bonds brought down yields and created a “portfolio rebalancing” effect that led

We are at the stage of the policy tightening cycle where history suggests a higher likelihood of accidents in financial markets

investors to reach into riskier assets for income. Government bond investors sold their government bonds to central banks and bought high quality corporate bonds instead; credit fund managers similarly added high yield bonds to their portfolios, while high yield investors moved down from BB to B rated debt. This led to a global inflation in asset prices, with the price of everything (from equities to art and fine wine) going up. The owners of such assets tended to be already wealthy, so inequality in society increased (prompting protest votes in referendums and propelling populism in general elections). Central banks regarded this as a known and necessary side effect, since inflation and economic growth also rose due to lower financing and debt servicing costs.

If we believe all this to be true, then we must also believe that when QE is reversed and becomes Quantitative Tightening (QT), those portfolio effects should also turn. This year, we have already seen sovereign bond yields around the world starting to rise, helping risk-averse investors achieve their income targets without taking so much credit risk. This has led to the "yield tourists" in higher-yielding asset classes starting to move back up the quality curve, pushing risk premia upwards, lifting borrowing costs and dragging down the price of risky assets.

So far, QT has mainly been a feature of US monetary policy and the US Fed's balance sheet: the central bank's holdings of US government bonds, mortgage-backed securities and other assets is expected to shrink to around \$3 trillion in two years' time, from a peak of over \$4 trillion between 2015 and 2017. Whilst the Fed is not actively selling bonds, the absence of its market presence as an ongoing bond buyer is highly significant, especially at a time when supply is only set to increase. US President Trump's tax cuts and the ongoing increases in fiscal burdens caused by an ageing population mean that we will see budget deficits of well over \$1trillion per year for the foreseeable future. More bonds are coming to market, but the biggest buyer has gone.

The ECB is also starting to exit QE, first by reducing its monthly bond purchases, then by cutting them altogether by the end of this year. This is set to happen despite the turbulence in Italian bond markets and also despite a stubborn core inflation rate stuck at around 1%, well below the ECB's 2% target. Could ECB President Mario Draghi be about to make the same mistake as his predecessor Jean-Claude Trichet in 2011, when he tightened monetary policy too early, putting brakes on a fragile economy whose only inflationary pressures came from higher oil prices?

Could Mario Draghi be about to make the same mistake as Jean-Claude Trichet in 2011, tightening monetary policy too early

ASSET CLASS ALLOCATION

In 2018 we decided to de-risk portfolios by reducing overall Equity levels (concentrating our Equity exposure into our STAR flagship strategy) and cutting exposure to the most cyclical credit exposure (in favour of higher rated issues). This proved to be crucial.

2019 will be just as challenging, so we will be continuing this trend.

These will be the main moves that we will be implementing:

- Reduce equity exposure to lowest levels since 2009
- Increase average credit rating of our fixed income exposure
- Increase exposure to Cash Plus strategies (short-dated high quality corporate and government bonds) as a diversifier in the case of a more pronounced macroeconomic slowdown

Within Fixed Income, we remain overweight in Financial debt. We constantly reassess our investment thesis, and the conclusion at present remains the same: irrespective of mark-to-market swings, we do not believe that the likelihood of receiving both the income and the principal at expiry has fallen.

Indeed, large financial institutions have never been better positioned to deal with potential liquidity and credit shocks.

As far as equities are concerned, we must be cautious ”

STAR is perfectly positioned for this higher volatility regime

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High Yield (HY) Debt has benefited since the Lehman Crisis from the so-called Goldilocks scenario, in which growth is strong enough to fuel earnings, but not so much to force interest rates significantly higher. This has kept default rates low, at a time when the yield-tourists were happy to go down the capital structure in order to lock in good income.

As 2-year Treasuries yield 2.7%, with little risk, Non-Investment Grade businesses are less attractive on a risk-adjusted basis. This is what caused US HY spreads to widen more than 100 basis points (1%) in barely two months.

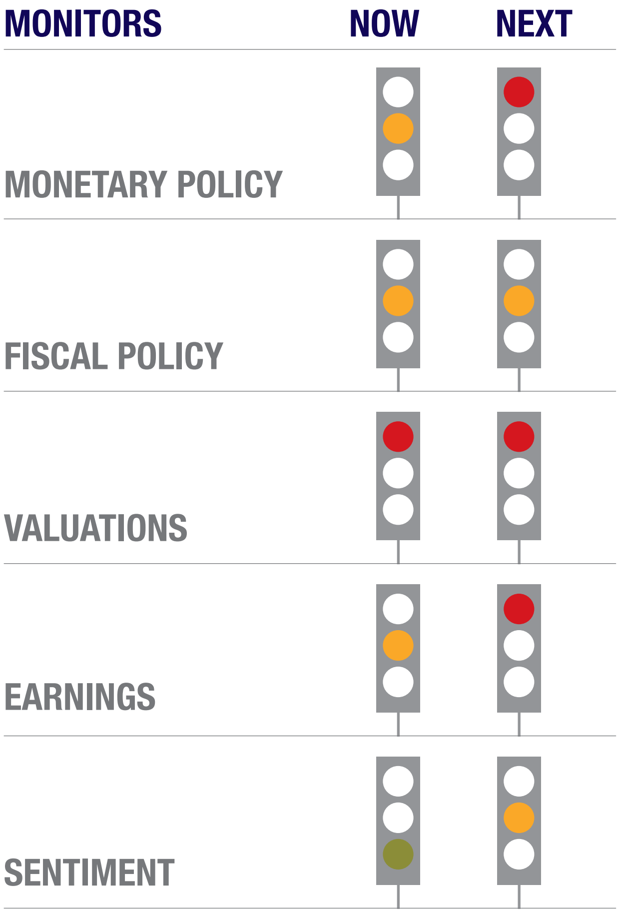
A big worry is the fact that the market value of the Investment Grade (IG) rating bucket just above junk (BBB) has swollen to $3trillion, more than two times the level a decade ago. It is now almost three times the size of the entire US HY market. Any potential downgrades of that paper (not unlikely as the cost of debt keeps going up) would have a deep negative impact to the HY universe.

As far as equities are concerned, we must be cautious. The world is slowing down, equities are expensive in many cases, rates are rising, and QE is no more.

Decelerating economic activity is expected to dampen top line growth and profit margins are under increasing pressure. Reduced excess liquidity, rising US short-term rates and higher equity-risk premiums (driven by heightened volatility and weaker investor sentiment) all suggest limited scope for multiple expansions.

This means that we need to be ready for when equity markets dislocate further.

STAR is perfectly positioned for this higher volatility regime.


MONITORS
NOW
NEXT
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FISCAL POLICY
VALUATIONS
EARNINGS
SENTIMENT

DEVELOPED MARKETS OUTLOOK

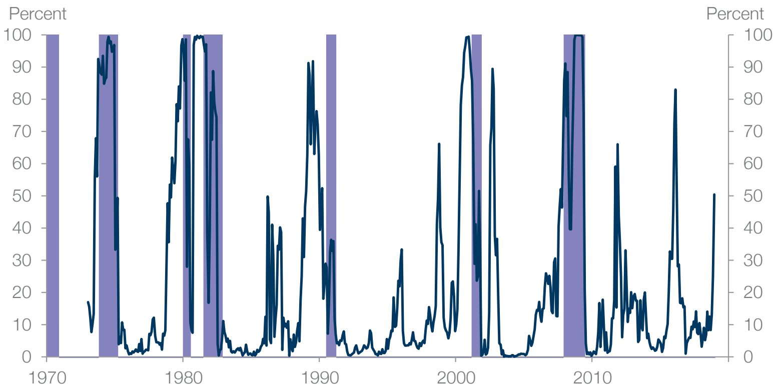
US ECONOMIC OUTLOOK

- **2018 momentum spills over into early 2019 but economic growth is set to slow down**
- **Recession risks continue to rise for 2020**
- **A more dovish Fed does not imply early rate cuts**

A significant sell-off in risk markets, a partial Federal shutdown, profit warnings and weaker data have combined to raise the spectre of a recession and put an abrupt end to monetary tightening. Goldman Sachs (GS) have combined information from the yield curve and credit spreads (see chart) showing that the markets are discounting a recession risk of almost 50% in 2019. We believe (as do GS) that this is vastly overstated. It is important to remember that the underlying data does not point to an elevated risk of a contraction this year. However, as we stated last quarter, 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, rising interest rates, a difficult financial backdrop and a general global economic slow-down. Despite the 2018 growth momentum spilling over into the first half of 2019, growth is set to slow to a more sustainable 2-2.5% range, although the risks are on the downside this year.

Of particular concern is the slowing housing market

Recession risk over next year implied by yield curve and credit spread combined.



Source: Goldman Sachs

Consumers have been the mainstay, helped by a strong labour market, higher wage growth, solid returns from the stock market, a supportive housing market and affordable debt levels. However, most of these are unlikely to be supportive this year. Of particular concern is the slowing housing market due to the cumulative impact of monetary tightening, and the impact of the near 15% drop in US stocks in the final quarter of 2018. Inevitably, skill shortages are beginning to appear with the labour market tightening setting the scene for a slow-down unless more workers return to the labour market, i.e. the workers participation rate starts to increase sharply. There is also concern over lacklustre capex despite the more favourable tax regime.

The underlying data does not point to an elevated risk of a contraction this year

We argued last quarter that the Fed's dilemma will be to steer a course that does not risk a sharp contraction in activity yet keeps inflation steady. Indeed inflation has remained under control and the core PCE (US measure of inflation on personal consumption expenditure) is expected to remain close to the 2% target. In light of this, the Fed's more dovish stance is not really a surprise and we reiterate our view that the looming risks should lead to an earlier end to monetary tightening as a flattening yield curve increasingly factors in a recession in 2020. However, the market is probably being too bullish in pricing out all rate hikes in 2019 as the economy is not facing an imminent threat of a recession.

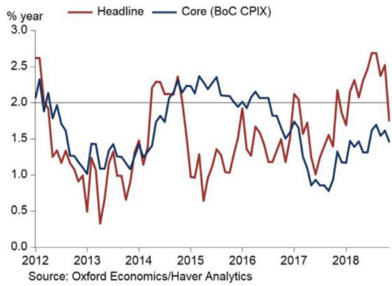
CANADA ECONOMIC OUTLOOK

- Further growth downgrade for this year but no recession
- Bank of Canada on hold for now

Canada has not been spared the global economic and market forces at play. To some extent the drop in energy prices and trade conflicts have impacted Canada more than most of the G7 economies. As a result, growth is likely to slow further this year to c.1.5%. The Bank of Canada (BoC) estimates that the sustained drop in oil is expected to lower growth by up to 0.5% over the next two years. Due to recent trends both actual and potential output growth estimates have also been lowered

Consumer spending continues to ease from the post-2015 strength, with most underlying forces likely to provide some restraint going forward: slower real disposable income growth, less exuberant labour market, higher interest rates, a slower housing market and the constraining impact of macro-prudential measures. Investment should still be a bright spot (following the sharp slow-down in the wake of the contraction in the energy sector). The BoC will closely monitor the impact of tighter policy on consumers. Households have benefitted from low rates, a strong labour market, low inflation, steady wage growth and higher debt levels. However, almost all of these underlying forces will be less supportive in coming quarters and consumption is likely to slow.

Lower Gasoline prices



Source: Oxford Economics/Haver Analytics

The BoC sat on its hands at the January meeting, having gradually tightened policy last year (to leave the key rate at 1.75% at the end of 2018). It reaffirmed the gradualist path, which is not surprising given the fact that inflation is hovering below target and the economy is slowing. A further rate hike is unlikely in the first half of the year unless there is a significant turnaround in global economic sentiment. We now expect rates to peak at 2% by the end of the year, but the clear risk is that the BoC does nothing at all, as inflation eases further and growth undershoots. Apart from household activity the other key risk for the BoC is trade disruption. Trade relationships with the US and China are critical. The new trade agreement with the US provides some stability but this has to be tempered by slowing domestic growth. The recent spat with China in the midst of slowing growth does not bode well. As almost a quarter of GDP is accounted for by net trade, any disruption in trade flows will be a drag on economic growth and will be an important source of uncertainty for the BoC. Accurate economic modelling is difficult but a bearish scenario (on further trade disruption with China) would imply growth slows to just 1-1.5%.

Consumer spending continues to ease from the post-2015 strength, with most underlying forces likely to provide some restraint going forward

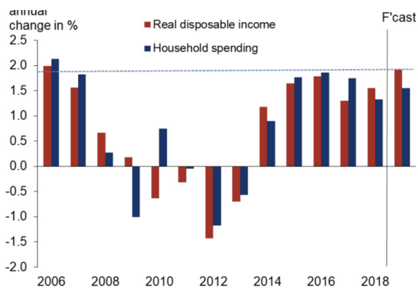
EUROPEAN ECONOMIC OUTLOOK

- Eurozone growth slowing amidst conflicting forces
- Sentiment hit from politics and external factors will need to be closely watched
- The ECB unlikely to raise rates in 2019 but QE has ended

European growth has continued to disappoint, with momentum slowing and further downward revisions to consensus projections. It would seem that Germany was close to a contraction in the final quarter of 2018, 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 1.5%, but there are counter-veiling forces at play.

Domestic consumption in particular has been rather weak, but consumers should be supportive going forward, with relatively strong job creation, buoyant employment expectations, upward momentum in both nominal and real wages (real income growth likely to be at its fastest since 2006) and a pick-up in consumer loans from regional banks. Capital investment has also been marginally stronger as companies have finally taken advantage of low borrowing costs and greater liquidity. In addition, fiscal policy will 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.

Households



Source: Oxford Economics/Haver Analytics

However, there are offsets, both external headwinds and domestic threats: External trade impediments remain: the stronger Euro, uncertainty from the trade conflict with the US (no early resolution seems to be in sight) and a fall in exports to China (German exports particularly vulnerable). Net trade, which contributed positively last year, will most likely be neutral at best this year. Domestically, the European political landscape is at times toxic and may yet impinge on consumer sentiment offsetting some of the positive forces that should be at play.

The ECB took the first step of policy normalisation by ending QE in December last year, having bought assets of €2.5 trillion over the past 3-years. It has provided forward guidance which is consistent with a very gradual rate hike trajectory. We believe that, given the underlying economic fundamentals, a rate hike this year is highly unlikely. Indeed, it may well be that if the negative economic forces take the upper hand policy will be on hold well into 2020.

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UK ECONOMIC OUTLOOK

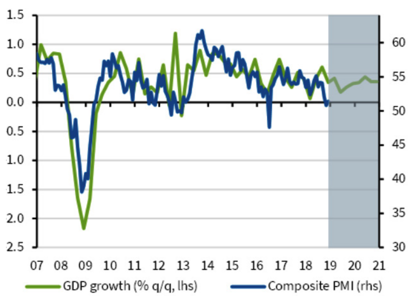
- A sluggish economy with significant political risks
- Short-term fiscal boost is in place
- Brexit uncertainty hampering corporate behaviour

There continues to be immense uncertainty over the likely Brexit outcome. In the meantime the economy flounders and we have to make judgements on the path for monetary policy and ultimately financial assets. In terms of the economy, we continue to examine the underlying trends and focus on likely risks and opportunities from a hard or soft Brexit. The outlook is for subdued growth, and it is difficult to see a significant upside boost in the event of a more conciliatory outcome, purely as a result of the global economic slow-down.

The economy has certainly not gone into recession; since our last update it has performed in line with expectations. Service and manufacturing sentiment improved somewhat in December, but this still does not disguise the fact that confidence remains at the lower end of the scale seen since 2010.

The economy also continues to be hampered by three key areas: a weakening consumer, weak capital investment and the fading positive contribution from net exports. The final quarter retail data was mixed and the most recent analysis by the British Retail Consortium highlights the worst outcome during Christmas for a decade. It would seem that, as expected, the sales trend has reverted lower as the positive boost from the summer faded. The housing sector does not provide a positive backdrop either, with the Halifax House price index up a meagre 1.3% (yoy) at the end of last year.

UK composite PMI (output) versus GDP



Source: Barclays

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Investment has been slowing for well over a year having been a bright spot over the previous five years. Investment intentions from the Bank of England (BoE), Confederation of British Industry (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.

However, as a positive offset, fiscal policy was loosened on the back of significant positive revisions to borrowing projections by the Office of Budget Responsibility (OBR). This led to a significant uplift in NHS spending and a generous lift 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%. The lower inflation profile should also provide a welcome boost to consumers as real disposable income is likely to be lifted even with subdued nominal wage growth.

Most recent parliamentary moves seem to have made the likelihood of a hard Brexit less likely and the chances of a prolonged withdrawal more likely. The probability of a general election is still relatively low given the fact that there has to be a two-thirds vote for an early dissolution of parliament. The situation on Brexit remains fluid and the main conclusion for us is that the BoE will remain a reassuring presence in term of keeping policy stable and continuing to provide liquidity to the key financial sector if needed in the event of an adverse outcome.

EMERGING MARKETS OUTLOOK

- Emerging Markets contagion fears less pronounced
- Chinese growth will be lower due to the trade war and lower domestic demand
- Indian growth holding up well but INR weakness and politics a concern
- Brazil has stabilised

A tough year is finally behind them. Emerging Markets (EM) assets got hit in 2018 by rising US interest rates, a shrinking Fed balance sheet, a stronger US dollar, weakening commodity prices, trade conflicts and a volatile political landscape. Add to these external factors a more challenging domestic environment in a number of countries and you end up with a perfect storm. 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.

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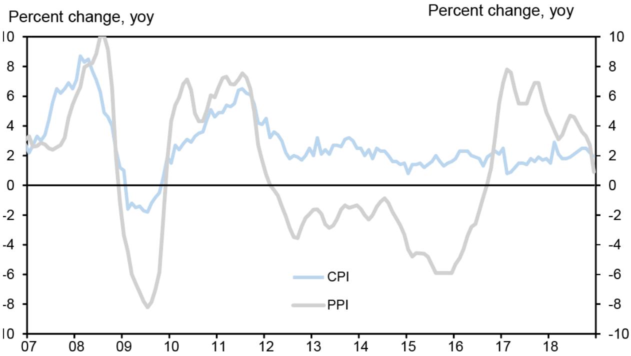
Our positioning in EM assets and economic analysis is driven by an examination of key sovereign risk indicators such as reliance on external debt, Foreign Direct Investment (FDI) flows, government deficits and debt levels and the importance of external sector verses domestic growth and possibility of policy support. This analysis suggests that widespread economic contagion is unlikely, but we remain wary of financial asset price movements outweighing underlying economic strength in a number of countries.

China

The trade conflict with the US (driven by the determination of the US to use tariffs to correct its huge trade deficit with China) has sapped economic growth… 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. Even a positive trade outcome is unlikely to prevent an end to a more adversarial attitude from the US towards China in terms of technology and security issues. Economic models suggest that a significant trade war would reduce Chinese growth by anywhere between 2-3% over the next couple of years, but the medium-term outcome could be better in the event of a significant policy response.

China CPI and PPI Inflation



Source: Goldman Sachs

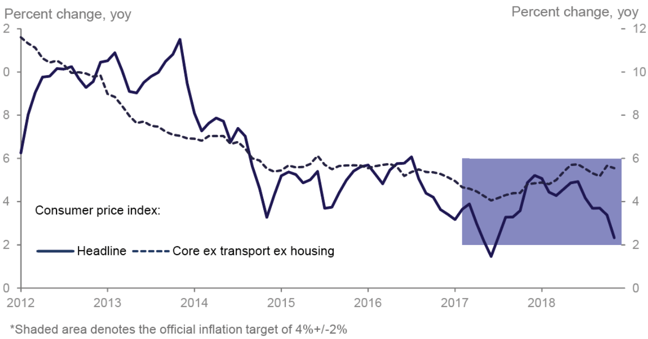
Chinese growth has been easing, with domestic demand in particular hit hard. The authorities have responded with a whole string of fiscal initiatives including personal tax changes (a move to itemised deductions), sales tax and tariff cuts to boost auto sales, infrastructure measures and direct intervention in housing and land purchases. On the monetary front, the People's Bank of China (PBoC) has cut the Retima Retrieval Reference (RRR) by 1% already this month 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%.

The fears of an outright trade war may evaporate but there is unlikely to be an early end to the uncertainty

India

The economy slowed in the second half of 2018 from the elevated 8% recorded in Q2 as monetary tightening had an impact, as did the clamp down on the non-financial sector lending practices. 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. The political landscape has also become more challenging ahead of the general election (this Spring) 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 won last time round. Some polls point to a hung parliament, which will hamper policy-making at a critical time.

CPI Inflation falls



Source: Goldman Sachs

This period has coincided with a change in leadership at the Central Bank and a more government-friendly, dovish stance emerging. The new Governor of the Reserve Bank has hinted that monetary loosening is on the cards, with inflation stable (at 4%) and likely to move lower given the fall in oil prices in the final quarter of 2018. This fall was a boon for the current account and for the fiscal deficit, providing a much-needed win for the government.

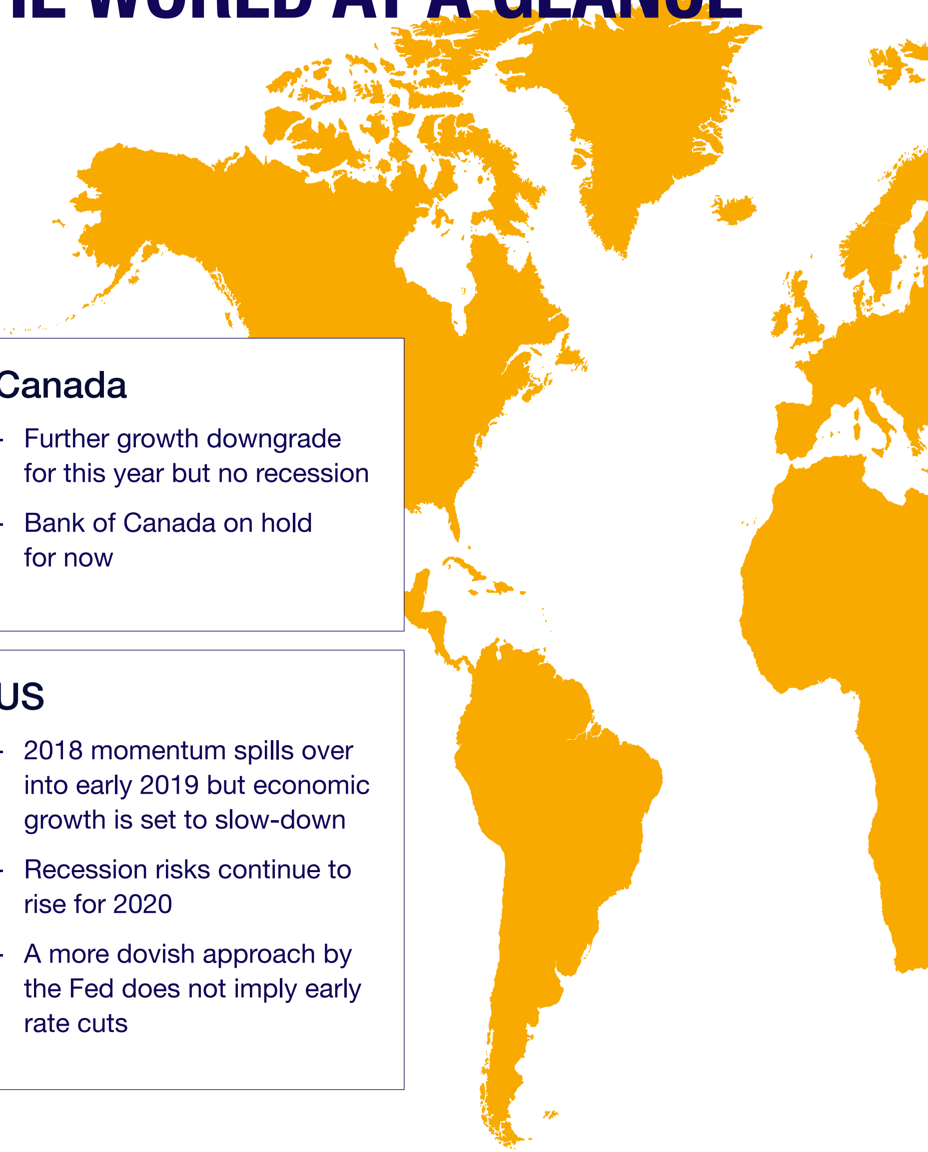
The economic growth projection for 2019 has been revised a tad higher to 7%, largely due to the likelihood of looser monetary and fiscal policies and the lower oil price.

Brazil

The new right-wing President is in power and markets have rallied, hoping that he will pursue fiscal and policy reforms to aid economic recovery. It is unlikely that there will be a rush to pursue significant pension reforms straight away but the signs are hopeful. There also seems to be a determination to bolster external confidence whilst implementing incremental domestic reforms to aid growth. This stable environment has led us to revise growth projections higher for 2019 to c.2% (i.e. double the 2018 growth rate).

There also seems to be a determination to bolster external confidence whilst implementing incremental domestic reforms to aid growth

THE WORLD AT A GLANCE



Canada

- Further growth downgrade for this year but no recession
- Bank of Canada on hold for now

US

- 2018 momentum spills over into early 2019 but economic growth is set to slow-down
- Recession risks continue to rise for 2020
- A more dovish approach by the Fed does not imply early rate cuts

UK

- A sluggish economy with significant political risks
- Short-term fiscal boost is in place
- Brexit uncertainty hampering corporate behaviour

Eurozone

- Euro Zone growth slowing amidst conflicting forces
- Sentiment hit from politics and external factors will need to be closely watched
- The ECB unlikely to raise rates in 2019 but QE has ended

Emerging Markets

- EM contagion fears less pronounced
- Chinese growth will be lower due to the trade war and lower domestic demand
- Indian growth holding up well but INR weakness and politics a concern
- Brazil has stabilised

FIXED INCOME
GOVERNMENT BONDS:

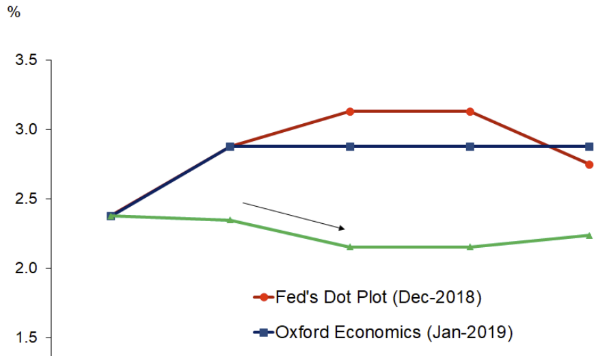
London & Capital actions

- **Duration has been raised gradually through Q4 2018 as the US yield curve flattens**
- **Government bond allocation underweight to be closed in 2019**

Rationale for underweight

The Fed has adopted a more dovish tone in recent weeks as tightening financial conditions have led to concerns over a significant economic slow-down. The global tone has definitely shifted and this has led to a more constructive backdrop for government bonds. Although, the Fed is not expected to cut rates this year, they are unlikely to rush into a rate hike this quarter given slower growth and lower inflation. However, the market has probably prematurely priced out all rate hikes for 2019. We have already shifted duration higher and will look for opportunities to add more duration through the first half of the year on any pull backs.

US: Federal funds rates expectations



Source: JP Morgan

Risks

The risk going forward is that the curve inverts (i.e. 10 and 30-year yields are lower than short-end yields) providing a clear signal that the US economy will either slow significantly or face the prospect of recession over the next couple of years. We re-iterate our view that as the economic projections begin to factor in weaker growth in the second half of 2019 and inflation moves lower, the longer end of the curve is expected to benefit.

Eurozone government bonds also face some of the issues that the US Treasury market does, but also has to contend with a number of Euro-centric features. The end of QE was well flagged and should not have much of a negative impact on sentiment, particularly as interest rates are unlikely to rise until 2020 given the growth and inflation outlook.

CORPORATE INVESTMENT GRADE (IG)

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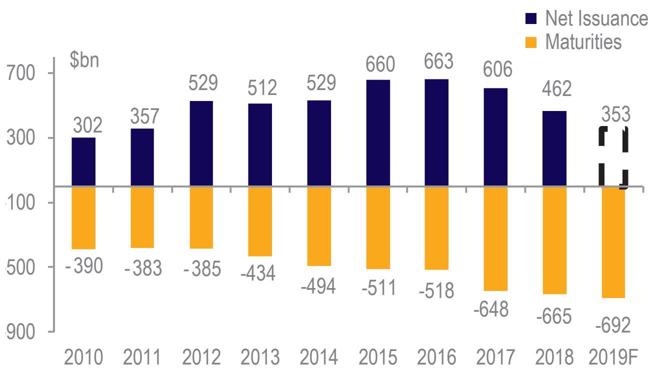
- **Improve the credit quality within portfolios with selective overweight positions**

Rationale for selective overweight

Slowing growth but no recession, reasonable corporate leverage and interest cover, good cash flow, high cash balances and relatively low refinancing risks are all supportive of higher grade corporate bonds. Despite fears of rising corporate leverage and potential refinancing risks, it is important to stress that generally higher-rated companies have been actively prolonging the maturity of their outstanding debt. The chart below shows that the net supply will fall despite fears over high grade issuance that is set to fall by almost a third in 2019. There is a bias towards higher grade corporates with a focus on strong cash flow including regulated industries.

Net supply is expected to fall by another 24% y/y in 2019



Source: JP Morgan

Risks

A further sharp rise in sovereign bond yields would overwhelm relative spread compensation and would risk an abrupt end to the economic expansion, in turn threatening corporate prospects. A damaging rise in credit risk (i.e. a further widening in credit spreads) would be a further danger, particularly for BBB credits. These lower rated IG bonds have faced a more challenging environment and selectivity will be crucial. We are underweight in our clients' portfolios in sectors such as retail, energy and consumer cyclical.

FINANCIALS STRATEGIC VALUE PLAY - STRATEGIC OVERWEIGHT:

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- Strategic overweight maintained particularly in AT1 debt; US preferred stocks (hybrid bond/equity securities) and European CoCo (contingent convertible) bonds
- Taking advantage of shorter-dated AT1 debt with high coupon step-ups

Rationale for strategic overweight

LCAM strategies have been overweight 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 difference in performance between US and European names, reflecting the divergence in underlying stock performance. The AT1 debt market has been undermined by the sharp fall in banking stocks due to worries over European growth, the end of QE, trade wars and faltering bank stocks. Although we have been extremely selective in terms of individual bank exposure it may be that new names will be added for tactical valuation reasons.

The short-term negative influence of stock prices on bank spreads does not outweigh the continuing strengthening in balance sheets. Tighter regulations have driven a significant improvement in bank balance sheets with higher CET1 ratios, lower risk weighted assets and a significant increase in high quality assets.

It is likely that price volatility will be elevated at times, but given the strength of the balance sheets the lure of high coupons should be of paramount importance. We would also argue that bank bond prices have already discounted a lot of negative news and have increasingly priced in greater risk. However, there has also been an over-emphasis on the income side of the equation (i.e. lower profits as economies slow) instead of the inherent strength of banks, as highlighted by the results of the onerous stress tests carried out by the regulators.

Risks

De-regulation steps, a significant stock market correction and a spike in sovereign yields are all potential risks, 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.

CORPORATE HIGH YIELD – SELECTIVE AND UNDERWEIGHT:

London & Capital actions

- 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 (HY) sector is still supported by reasonable leverage and interest cover, high cash balances and relatively low refinancing risks. This does not mean that a scatter gun approach can be taken to allocation, as detailed due diligence on sectors and individual credits will need to be carried out.

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 HY 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.

EM IG AND HY DEBT – SELECTIVE OVERWEIGHT:

London & Capital portfolio positioning

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

London & Capital strategies have benefitted from a selective approach to EM debt with the overweight in India and China. We will maintain an overweight position for our clients 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

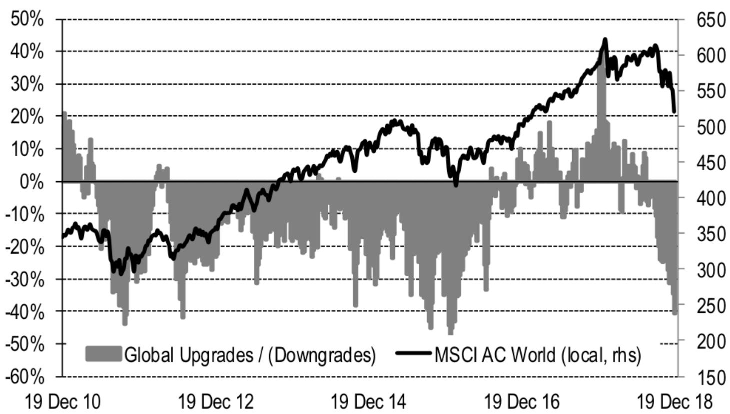
An outright trade/currency war is clearly a risk, particularly for the higher beta emerging market economies. However, our selective exposure should shield the portfolio.

EQUITIES OVERVIEW

2018 was the worst year for equity markets since 2008, with the MSCI AC World down c.7.5% in USD.

Our cautious equity market view in 2018 was proved correct as high valuations and over-optimistic earnings expectations resulted in disappointment and downgrades.

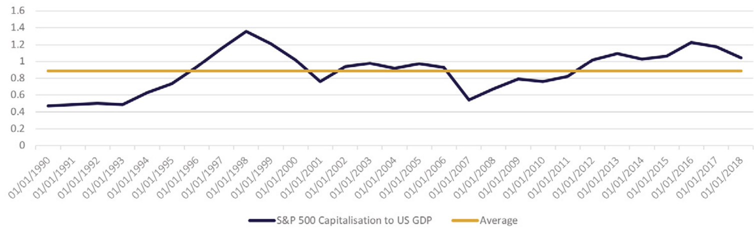
Global Equities – Net Earnings Upgrades V. Downgrades (%)



Source: Citi

A host of political, economic, sector and stock-specific news has caused recent market weakness. Longer-term the overarching concern is that the strong recovery in asset prices since the Financial Crisis driven by unprecedented monetary stimulus, hasn't been matched by the much more moderate recovery in the real world economy.

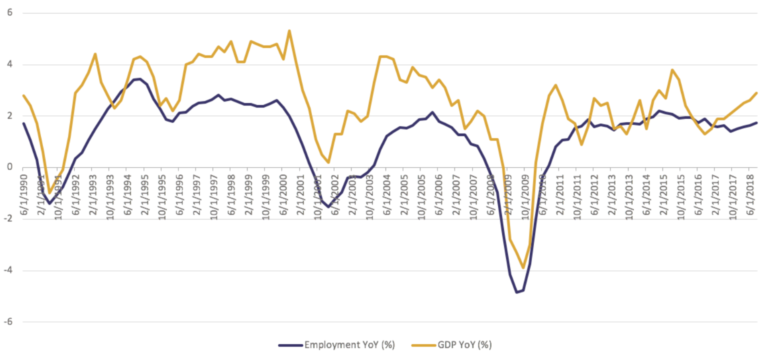
S&P 500 Compared to GDP



Source: London & Capital, Bloomberg Data

At this junction, employment (a concurrent indicator for equity markets) will be key; if labour markets remain around the current healthy levels then a marked recession is unlikely. However, corporates are suffering and may well look to cut costs (jobs). Currently, it feels too soon to invest more into equity assets until there is assurance that employment is going to remain firm.

Employment and GDP - Rate of change over 12 months



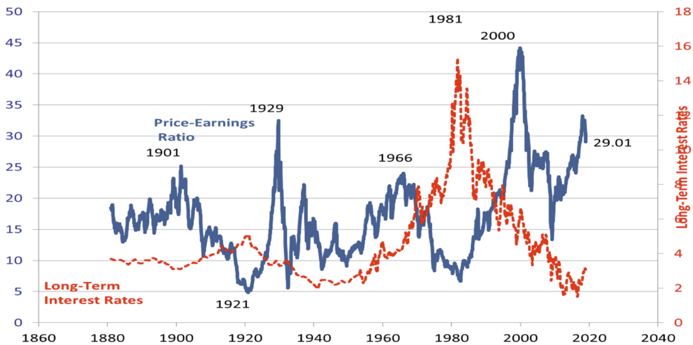
Source: London & Capital, Bloomberg Data

In the shorter term, markets are likely to remain volatile until there is more clarity in terms of earnings. However, investor sentiment has collapsed which is supportive as a contrarian sign but technical analysis is negative, showing a change in trend in the equity markets from uptrend to downtrend. Furthermore, valuations are still not cheap on a historical basis.

OUR POSITIONING

Overall, the next (or current) stock market fall is unlikely to have the same impact on the real economy as the 2008 Financial Crisis. Full equity valuations and high expectations suggest an asset price correction more akin to 2000, given it is financial assets that are stretched as opposed to the consumer.

Price earnings ratio (CAPE P/E10)



OBSERVATION	AVERAGE 6 MONTH FORWARD RETURN	AVERAGE 1 YEAR FORWARD RETURN	AVERAGE 2 YEAR FORWARD RETURN
One Standard Deviation Above Rising Momentum	21.61%	28.64%	7.97%
One Standard Deviation Above Falling Momentum	-11.28%	-16.10%	-22.41%
One Standard Deviation Below Rising Momentum	18.12%	26.94%	36.95%
One Standard Deviation Below Falling Momentum	0.20%	8.03%	30.88%

Source: L&C, Yale University
Notes: Momentum = trend change up or down (3 month measure).

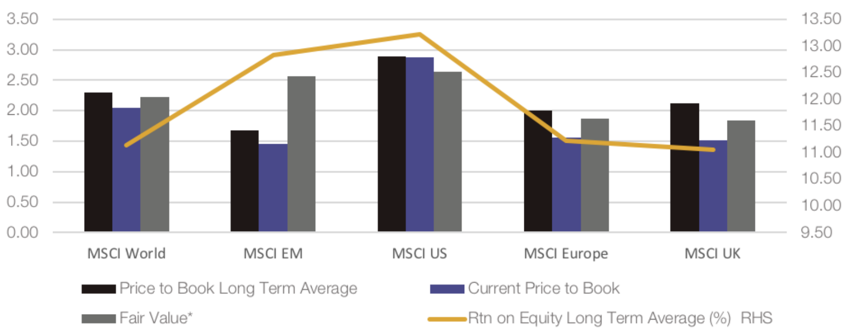
As a result, we still believe in being defensively positioned as growth decelerates. It is too early to be able to quantify the magnitude of the moderation in growth, and given the longevity of this cycle it seems intuitive to remain data-dependent before increasing exposure to economically sensitive investments in our clients' portfolios. There are also worrying data points occurring elsewhere, from US auto sales and housing to Asian and European Purchasing Managers Index (PMI) data.

It is a time to be patient and keep our powder dry rather than jump into equities. However, if one was to buy equities, then Emerging Market equities and certain European sectors (industrials predominately) are already pricing in a worsening growth environment. Conversely, US equities are vulnerable as expectations are still elevated and valuations are fuller. At least in Emerging Markets and European Industrials, there is the potential to be well rewarded for taking risk.

As always there are opportunities arising in equity markets, with (relatively) undervalued defensive growth assets starting to recover towards historical averages.

This type of company is well represented in London & Capital STAR portfolios. These stocks currently not only provide short term capital preservation but are longer term outperformers.

Regional returns and B/P



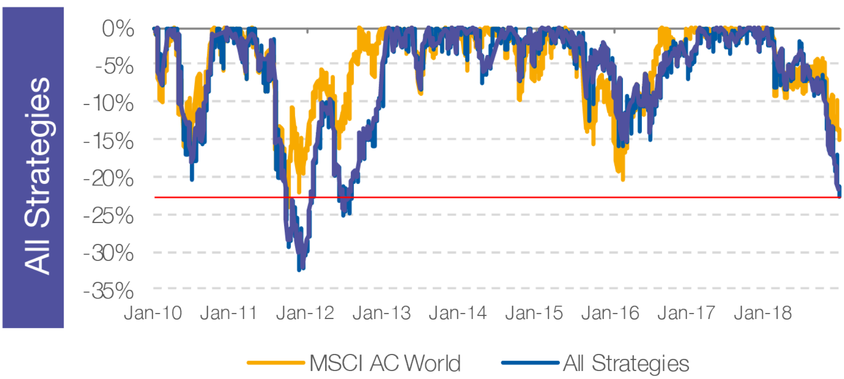
Source: L&C, Bloomberg Data

HEDGE FUNDS OVERVEIW

At an industry level, hedge fund performance in the 4th quarter of 2018 was disappointing. Evidence suggests that hedge funds were a significant contributor to equity market volatilit y in October as broad positioning in growth and momentum stocks, combined with relatively high leverage and net market exposure, led to an industry unwind which fed on itself and caused widespread underperformance.

The de-risking that occurred followed through into November. Only in December did it begin to bear fruit with a more robust return relative to a precipitous market backdrop. According to the HFRX Index, hedge funds fell -5.9% over the quarter, which was ahead of the -12.8% fall for the MSCI World but worse than what we would typically expect, suggesting elevated beta and negative alpha generation. The chart below (from Morgan Stanley) shows the level of gross exposure reduction from the high is in line with prior extremes post-2008 crisis:

Drawdown levels relative to 12-month highs



Source: Morgan Stanley

At the strategy level, directional equity long-short funds were the worst performing over the quarter, with growth-biased strategies in particular underperforming as this was the area that let the markets down. While managed futures strategies suffered in October, adjustments to trend-following programmes meant that bearish positioning emerged to deliver a positive return in December, achieving significant outperformance. Event-Driven, Credit and Distressed strategies lost ground over the quarter while the main bright spot was Merger Arbitrage, which was flat through the period. Among Relative Value strategies, the large multi-strategy managers were the underperformers as de-risking ensued, but dedicated Fixed Income and Volatility strategies performed well.

Industry assets have slid backwards of late as flows into the industry have turned negative, and performance has also detracted from assets under management. The overall industry stands at $3.2 trillion according to Hedge Fund Research (HFR), and their analysis also indicates new launches are just ahead of liquidations for the year (data to end of Q3). Due to a slowdown in overall launches and closures, it looks like less manager churn is occurring at the industry level. As we further edge towards the end of the cycle, we expect to see a stronger investor trend towards truly uncorrelated strategies as market participants look to insulate their portfolios against further market volatility.

We expect to see a stronger investor trend towards truly uncorrelated strategies"

OUR POSITIONING

London & Capital hedge funds are positioned to be truly uncorrelated to markets, and this proved to be the case with a small loss in October and a positive gain in December providing good diversification to traditional assets. November was more difficult for our managers, meaning that the quarter overall was slightly negative, but still significantly ahead of the benchmarks. This positioning will be maintained going forward in order to ensure we deliver meaningful value for clients into any further market volatility.

Our overall philosophy is unchanged as 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.

Moving forward, the L&C UCITS and L&C High Conviction Offshore hedge fund selections contain a core of lower risk, uncorrelated strategies combined with some higher risk/return trading funds which can add value in negative markets. As the cycle matures, we continue to see good opportunities to generate alpha against a backdrop of higher volatility, providing diversifying sources of returns for client portfolios:

Our positioning will be maintained going forward in order to ensure we 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 Advisor (CTA): Macro strategies have the potential to benefit from diverging global macroeconomic policies, especially in light of policy normalisation from the Fed. Medium-term CTAs are expected to benefit from any extended periods of risk-off sentiment while our short-term CTA is benefitting from a higher volatility regime. 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, some complex situations which provide 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.

FX

The US Dollar made small gains versus Sterling (-2%) and the Euro (-1.2%) in the fourth quarter 2018, but wider performance was mixed, leaving the trade-weighted Dollar index broadly unchanged.

The conditions for a trend reversal and US Dollar weakness look more favourable as we enter 2019. The widening growth and yield differentials that benefited the Dollar in 2018 appear to have peaked. As the year closed, US economic data showed signs of slower growth momentum. In turn investor expectations of future Fed monetary policy quickly adjusted lower, eventually only pricing a c. 20% chance of a rate hike in 2019. In addition, the price of oil, which conventionally has a negative correlation with the US Dollar, has stabilised after a period of persistent losses. However, fading US exceptionalism versus the UK and Europe will not necessarily translate into immediate Dollar weakness.

US growth may be decelerating, but convergence with the UK and Europe will be slow given their own fragile economic conditions. Tentative signs of stability returning to Europe faded in the fourth quarter with economic releases again disappointing against expectations and survey data pointing to ongoing weakness. Leading indicators and the balance of data surprises steadied in the UK, but it is far from a picture of health. Aside from economic conditions, political uncertainty across Europe (French unrest, Italian budget negotiations and Brexit) continue to weigh on both Sterling and the Euro. The Brexit countdown will be crucial for Sterling direction in the first half of the year, but will also be important for the Euro. An orderly UK exit would lift a cloud of uncertainty and probably trigger a relief rally in both currencies. If this coincides with less divergent growth and monetary policy the recovery will be more resilient. Although it is not our base case, under a scenario of significant global slowdown and risk aversion, the US Dollar would be supported due to its safe haven credentials.

Yield differentials were an unreliable driver of currencies in 2018, but the US Dollar still maintains an advantage despite the December pull back. Based on recent communications the Federal Reserve may be closer to the end of its tightening cycle than originally thought. However, policy normalisation in Europe has been slow, and although QE has now ended the first rate hike looks increasingly distant. Likewise in the UK investors are no longer pricing any Bank of England rate hikes for 2019. It may take more than a Fed pause on rate hikes to soften the US Dollar, because arguably more important is the balance sheet reduction that has been quietly ramping up to c. $50 billion per month. If unaltered, quantitative tightening will continue to reduce liquidity, tighten conditions and support the US Dollar.

Peaking growth and yield differentials have set the conditions for Dollar weakness this year, but an immediate recovery in Sterling and the Euro should not be taken for granted - any recovery is dependent on European/UK economic and political stability. An orderly Brexit that removes uncertainty and unlocks cross-border investor flows may just be the catalyst required.

The Brexit countdown will be crucial for Sterling direction in the first half of the year.

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 Hong Kong and Barbados and are regulated by the FCA (UK), the SEC (US) and SFC (HK).

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