London&Capital

MONETARY POLICY IN FULL SWING

Global Macro & Market Outlook
Third 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.

Call us on **+44 (0)207 396 3200** or visit **londonandcapital.com**

CONTENTS

Global Macro & Market Outlook
Introduction 2
The key macro risks 5
Summary of asset views 7

Developed Markets Outlook 9
US 9
Canada 12
Europe 15
UK 18

Emerging Markets (EM) 21
China 21
India 22

The World at a Glance 24

Fixed Income 26
Government bonds 26
Corporate investment grade bonds 29
Financials 32
Corporate high yield 34
EM IG and HY debt 35

Equities 36
Overview 36
Our positioning 38

Alternatives 40
Overview 40
Our positioning 43

FX 45

INTRODUCTION

Pau Morilla-Giner
Chief Investment Officer

On the back of the screeching handbrake turn by main Central Banks (led by the Fed), financial markets are exhibiting signs of extreme confusion: equity investors seem to think that the Fed is still in "insurance policy" mode, while bond markets are pricing in a much higher likelihood of recession.

Indeed, in May the value of global sovereign bonds with negative yields had doubled since last October to $11 trillion (only $1 trillion below the all-time high registered in mid-2016), while the US Treasury 30-year bond yield has breached the 2017 and 2018 lows.

At the same time, the yield curve has inverted again, and it is now much harder to ignore this renewed, downward direction of travel. When the 10 year yield is lower than the 3 month yield, it means that investors are betting on rates being lower in ten years' time than they are now. Since they are already very low, that is a powerfully deflationary signal.

Justification for this exceptionally gloomy view is not hard to find: The shocking trade attacks on Mexico and India (two very important US allies) within days of each other are clear signs that Trump has decided to take the gamble of latter-day protectionism and to go down a slippery slope.

If the US economy were to slow (and it already is, irrespective of the trade issues), Trump will respond by becoming even more protectionist.

The main danger is a profit recession in the US. The past decade has been great for companies, with record profit margins driven by lower corporate tax rates, low cost of capital and very moderate wage growth. The issue is not that margins fall off a cliff (we will not have inflation all of a sudden), but further improvement in margins are off the table and they are going one way: down.

On the back of the screeching handbrake turn by main Central Banks, financial markets are exhibiting signs of extreme confusion

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

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

Over the past two years the Eurozone economy has left its "normal" growth path following the global financial crisis and has dipped into the Japanification territory that has characterised that country for the past quarter of a century. Except that the Eurozone is not Japan: it is not a cohesive nation state with a joined up central bank and finance ministry operating in tandem.

To sum up, we are heading for a prolonged stagnation, driven as much by political uncertainty as underlying fundamentals

To sum up, we are heading for a prolonged stagnation, driven as much by political uncertainty as underlying fundamentals

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

KEY MACRO RISKS

These are the main risks, and our views on what they mean:

US economy losing steam

While the 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
- 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 long in the tooth. If we don't see a recession by mid-year, the current "boom" will be the longest in US history.

Rising 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. Corporate debt in the US 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.

LONDONANDCAPITAL.COM

Italy

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

Brexit

As the deadline to reach a deal approaches, concerns will likely build that a no-deal outcome — and associated UK and EU market turbulence — could become a reality.

Global trade

An escalation of global trade tensions in the coming quarters would likely have a direct impact on economic activity, potentially leading to uncertainty and market volatility.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

SUMMARY OF ASSET VIEWS

At London & Capital we 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 a higher cost of capital makes a dent on consumers, the impact of Trump's tax reform dissipates and the very low unemployment rates edge higher.
- 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 upon the next recession.
- Our MONETARY POLICY monitor is flashing GREEN, as Central Banks have changed tack and returned to accommodative stances.
- Our EARNINGS monitor is flashing 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.
- Our VALUATION monitor has been in RED for a few quarters now: after years of financial repression, few listed assets are below historical averages.
- Our 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 these indicators, our current Asset Allocation views can be summarised as follows:

CASH - Overweight

- Higher Cash positions are crucial. A portion of this cash should be in Gold, which is gathering momentum as the strongest currency in the world.
- Short maturity, high quality bonds are attractive as a safe haven.

We have reduced non-financial corporate high yield debt allocation, in favour of investment grade and higher quality bonds

FIXED INCOME - Neutral

- We have reduced non-financial corporate high yield debt allocation, in favour of investment grade and higher quality bonds.
- We are maintaining the core exposure to financial bonds in your portfolio.
- While friendlier to bonds than equities, at some point the macro/policy environment will separate good bonds from bad bonds. We are maintaining our emphasis on robust, quality companies in the corporate debt holdings in your portfolio.

EQUITIES – Underweight

- We are focusing on high quality equities that are well positioned to capture returns in the last innings of bull market, while being resilient on the way down.

ALTERNATIVES – Neutral

- We will continue to use truly uncorrelated alternative strategies to complement other holdings.
- It's important to avoid leverage and illiquidity.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

DEVELOPED MARKETS OUTLOOK

US ECONOMIC OUTLOOK

- **A dovish tilt by the Fed sets the scene for rate cuts this year**
- **Persistently low inflation proving to be a key concern for the Fed**
- **Record breaking growth phase to be extended into 2020**

The US Fed has pivoted decisively towards looser monetary policy at its latest gathering, with Jay Powell emphasising that they "have one overarching goal: to sustain the economic expansion, with a strong job market and stable prices…". The Fed has always had a broad mandate but it was notable that this was the starting point for his latest speech. It most likely implies that policy is set to be not just looser but for a much longer period as well. Of course it has the luxury of doing so as inflationary pressures continued to fade, with target inflation below 2%. Although the key Fed Funds rate was kept steady at the target range of 2.25-2.5% the scene was set for rate cuts through the course of this year, with a July cut a distinct possibility.

Policy is set to be not just looser but for a much longer period as well

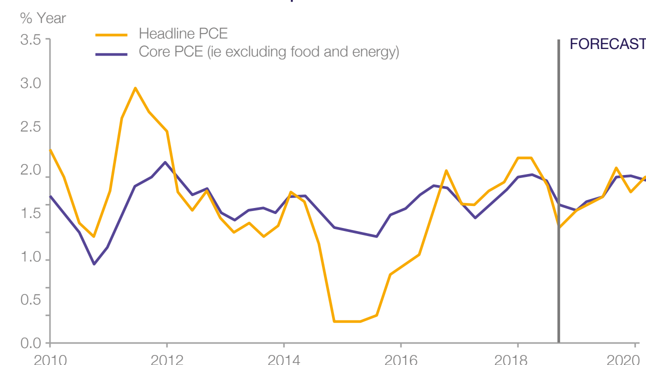
LONDONANDCAPITAL.COM

We believe that the market is rightly pricing in three 0.25% rate cuts by year end. It is worthwhile noting that the Fed also lowered its long-term neutral interest rate projection by a further 0.25% to just 2.5%. As a result, this economic cycle, which is already breaking records, is likely to be prolonged further.

The inflation backdrop, as with all advanced economies, is worrying given the remarkable monetary support over the past decade. The basic readings for the US are: market derived inflation expectations trending lower over the past six months, core Personal Consumption Deflator (PCE is the Fed's preferred target) also running persistently below the 2% level (it actually dipped to 1.6% in Q1), headline and core consumer prices running at or below 2%. The Fed has placed particular emphasis on the core PCE as this excludes the volatile food and energy components and is seen as more representative of underlying price developments. A further breakdown is available into cyclical (sensitive to general economic conditions) and acyclical (sensitive to industry specific conditions) sectors, with a concerning negative impulse from both over the past few quarters. In its projections accompanying the rate decision, the Fed projects this core PCE measure remaining below 2% through next year and only just returning to target in the long-term.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

Core PCE remains well below the 2% target



Source: OEF

Additionally, the economy has also slowed. Q1 GDP growth at 3.1% seems strong but this overstates the underlying pace of growth as final sales (stripping out stock building and net trade) advanced by just 1.5%, which was the slowest rate of growth since Q4 2015. Over the past quarter the data has remain mixed; a still tightening labour market, consumer demand holding up (albeit at a relatively subdued pace), service sector confidence holding up, capital expenditure easing significantly and weaker housing. Additionally, manufacturing confidence levels have declined pointing to an industrial recession. The continual threat of an escalation in the trade war between the US and most of its trading partners has had a negative impact on both confidence levels and real economic data and even though there may be a resolution in sight the situation is extremely volatile. A negative outcome would further lower the projected GDP growth rate of 2.5% this year and 1.75% in 2020.

CANADA ECONOMIC OUTLOOK

- **Growth downgrade to c.1.25%**
- **Bank of Canada on hold at present but monetary policy is set to become looser**

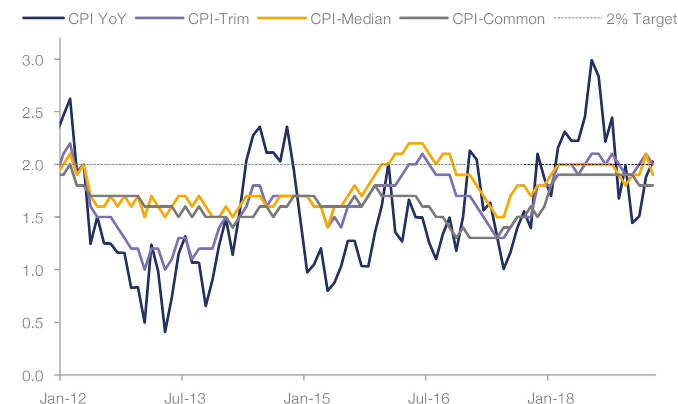
The Bank of Canada (BoC) turned dovish earlier in the year in the wake of weakening economic activity and lower inflation, but held off on an actual interest rate cut. They also held rates steady at the May meeting (at 1.75%) stating that there was “accumulating evidence that the slowdown in late 2018 and early 2019 is being followed by a pickup in the second quarter”. They also added that “continued strong job growth suggests that businesses see the weakness in the past two quarters as temporary”. As they now prepare to meet in July, they will have to contend with the dovish Fed tilt adding to the domestic information and of course a still volatile and uncertain trading backdrop. It is likely that there will be a more dovish bias but they are unlikely to follow any early rate cut by the Fed but the direction will be for lower rates.

It is likely that there will be a more dovish bias but they are unlikely to follow any early rate cut by the Fed, the direction will be for lower rates

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

The BoC cannot really ignore the simple fact that the economy is set for a period of sub-potential growth of c.1.25%, hampered by consumption and investment despite the upbeat message from the Central Bank. We concur that there will be a rebound from Q1, but this base effect volatility in growth should not detract from the generally disappointing news. Q1 2019 growth was weak, growing a mere annualised 0.4% which was only marginally higher than the 0.3% in Q4 2018. The GDP breakdown was slightly more encouraging than the headline number as domestic demand held up with a 3.5% rebound in consumer spending and a sharp jump in business investment. There was, however, a significant drag from net trade and residential investment. As with the US, the labour market has been strong; the economy added a record number of private and full-time jobs in April and despite lower job gains in May, the 12-month moving average rose to 37,800. The unemployment rate also fell to its lowest level since the mid-1970s. However, job growth is expected to ease in the coming months.

Bank of Canada Core CPI measures heading lower



Source: Citi

LONDONANDCAPITAL.COM

The pressure for a shift in policy is also likely to intensify if inflationary pressures continue to ease. There was a surprise jump in inflation in May but this is expected to be a temporary phase given sluggish economic growth. The BoC's key core inflation rate has been running below the 2% target for some time and a one-off jump above 2% is unlikely to sway policy-makers from focussing on the medium-term trend for lower prices.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

EUROPEAN ECONOMIC OUTLOOK

- **The ECB sets the stage for significant monetary loosening**
- **Persistent inflation undershoot proving worrisome**

Rather unsurprisingly the outgoing ECB President Mr. Draghi (at a key conference in Sintra) conceded the need for further monetary loosening by stating "In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required". Highlighting their deepening concern he added it is clear that the use of all policy tools is on the agenda: "Further cuts in policy interest rates" will be on the table "…and the APP still has considerable headroom", i.e. the asset purchase programme could or rather will be renewed.

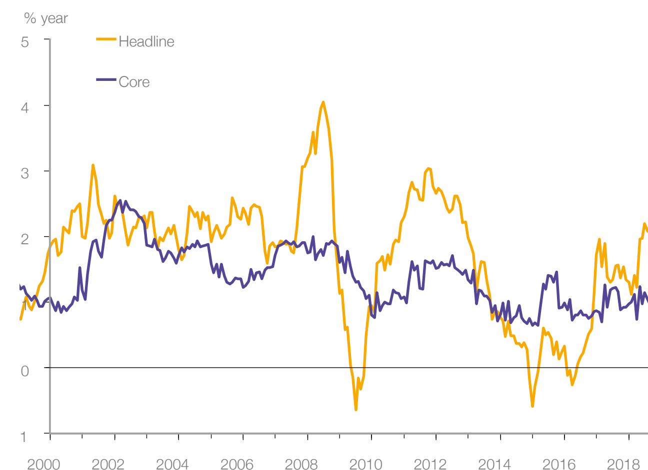
The aim is clear - continue to provide significant liquidity to prevent a recession and a further decline in inflationary pressures

LONDONANDCAPITAL.COM

This new guidance adds to the earlier mutli-pronged shift, including the intention of keeping the key interest rate in negative territory throughout this year. The ECB is also continuing to reinvest in full all redeeming securities for a prolonged period, with an upward adjustment on the cards later this year. Finally, the ECB has announced details of a new series of quarterly targeted long-term refinancing operations (TLTRO) that will run from September 2019 through to March 2021. The TLTRO3 interest rate will be set at a rather generous -0.3% which is just 0.10% above the MRO (the main refinancing operation) rate. The aim is clear - continue to provide significant liquidity to prevent a recession and a further decline in inflationary pressures.

The Central Bank has rightly viewed the significant drop in inflation expectations (to historic lows) as being a grim market perspective on the ECB's ability to meet its inflation objectives. In the background almost all measures of inflation have trended lower, with headline CPI slowing sharply to just 1.2% in May whilst core inflation dropped to just 0.8%. There has been some hope that a tightening labour market leading to higher wage growth could lead to companies boosting margins through higher prices. However, given the global economic slow-down (including the Euro Zone) this seems a faint hope. Inflation is set to remain around 1% below the 2% target for an extended period.

Plunging inflation expectations



Source: OEF

The good news is that Q1 GDP turned out better than expected and as a result Eurozone (EZ) growth this year is likely to be marginally higher than earlier projections at 1.25%. At this early stage, growth is expected to stabilise at c.1% in 2020, but this will be reviewed in light of monetary and fiscal decisions this year. However, the risk is still to the downside given the considerable loss of confidence and weakness across the industrial sector, as shown by the sharp decline in the German ZEW index in June. Industrial production was also particularly weak in Germany and Italy, leading to a 0.4% contraction in April. There is a worrying underlying tone, with capital expenditure and export related weakness standing out. The continual threat of tariffs and the slow-down in China is not just eroding confidence but is also hurting export growth. Thankfully, household spending has managed to offset the weakness elsewhere boosted by higher real disposable income, relatively supportive credit conditions and a continuing job growth.

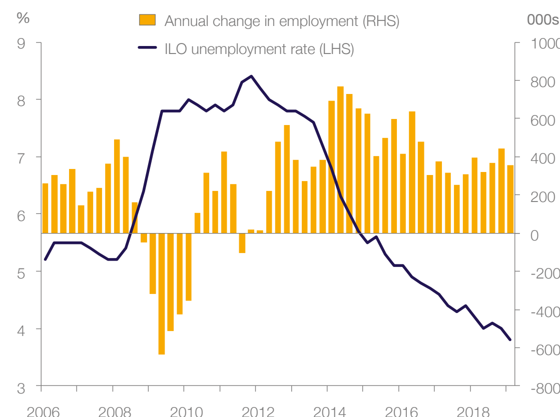
UK ECONOMIC OUTLOOK

- **Will a new leader lead to a better outcome? The economy and markets wait**
- **Further fiscal loosening seems to be on the cards**
- **Consumer demand remains relatively strong but this is the only good news**

An economy hampered by "political and Brexit uncertainty" has been a constant refrain used to describe the state of the UK over the past couple of years. Can this state of flux finally end? As we end this quarter, the Tory party is in the throes of electing a new leader and Prime Minister to steer the country towards the October 31st EU exit date and beyond. The no-deal Brexiteer, Mr Boris Johnson, is the favourite to be Prime Minister and unless there is a distinct shift in EU and UK strategy a hard Brexit remains the most likely outcome. But the situation remains fluid and an extension of Brexit is as likely as any other outcome.

In the meantime, the economy somehow continues to stumble along with the projection unchanged from the previous quarter, i.e. subdued growth and difficult to see a significant upside boost in the short-term even in the event of a more conciliatory EU outcome, due to the deteriorating global economic backdrop. The economy has managed to avoid a recession, with growth similar to the EU at c.1.4% this year. Consumers remain the mainstay performing ahead of expectations. The low unemployment rate, lower inflation, higher wage growth and resultant higher real disposable income have all been extremely supportive and are likely to remain so into the next year as well. There is some constraint from a slowing housing market as the level of mortgage approvals, transactions and house prices have all levelled off. A period of subdued growth is most likely.

A strong labour market has been supportive



Source: OEF

Away from household spending, confidence levels in manufacturing fell below 50, their lowest level since July 2016, as both external and domestic orders fell at the fastest pace in over four years. The construction PMI also fell and service sector confidence has stagnated. All of this is clearly negative news. The economy also continues to be hampered by weak capital investment and the fading positive contribution from net exports.

Fiscal policy has already been loosened due to significant generous revisions to borrowing projections by the Office for Budget

We believe any tightening in a period of sluggish growth and easing price pressures will be foolhardy

Responsibility (OBR). This led to a large uplift in NHS spending and a generous rise to tax thresholds, providing a small positive boost to the economy in contrast to the previous projection of a drag of almost 0.5%. It is pretty clear that whoever takes over the mantle of PM is set to use fiscal policy pro-actively adding to the stimuli already in place.

The Bank of England's stance in the coming months will need to be watched closely as some hawkish MPC members are indicating concerns over wages despite weak overall growth and the changing global monetary landscape. We believe any tightening in a period of sluggish growth and easing price pressures will be foolhardy.

EMERGING MARKETS OUTLOOK

- **Emerging Markets (EM) contagion fears are less pronounced but growth has weakened**
- **Chinese policy support in response to slowing growth**
- **In India the re-elected PM Modi to use a reform agenda and monetary policy to boost growth**

London & Capital Asset Management clients' positioning in EM assets and economic analysis is driven by an examination of key sovereign risk indicators such as reliance on external debt, foreign investment flows, government deficits and debt levels, the importance of external sector verses domestic growth and the possibility of policy support. This analysis suggests that we should remain selective in our risk apportioning.

China

There is the prospect of a face-to-face meeting at the G-20 meeting between the US and Chinese leaders to thrash out a trade deal that may avoid a damaging increase in tariffs. This next tranche of restrictions would be across the remaining $300 bn of Chinese imports into the US, with almost 60% on consumer goods. Goldman Sachs have estimated that the tariffs already in place will reduce growth by 0.15% over the next three years. A further escalation would raise this potential drag on growth to just over 0.5%. As always the indirect impact through the longer-term disruption to trading channels is important and may well add to the projected slow-down.

The trade issue has added to the general woes within the domestic economy, which has seen growth slow to just over 6%. It is notable that the 2019 Government Work Report (GWR) lowered the growth projection to 6-6.5% whilst holding out the prospect of further fiscal support and loose monetary policy.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

Further counter-cyclical adjustment policies were announced in a recent State Policy document, allowing local government special bonds as equity for infrastructure projects and boosting financial institution support for these projects through loans. This fits in well with the additional room given for special purpose bonds, with the quota raised from 1.5% to 2.2% of GDP. There are likely to be further fiscal measures as well. The budget deficit is set to rise to over 6% this year from 4.7% in 2018.

On the monetary front, the People's Bank of China (PBoC) could cut the RRR twice more 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. More controversial is the weakening in the RMB in recent months, which may well accelerate in the event of the trade war intensifying. 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.

India

P.M. Modi was re-elected with a stronger mandate for his ruling BJP party. There has been some disappointment amongst foreign investors with the pace of economic reform during his first term. But clearly the domestic audience responded positively to the myriad of micro and macro changes due to their significant positive impact upon the masses. In a sense the past five years laid the ground work and the next term should see these measures coming to fruition. However, it is unlikely that in the short-term the growth profile will be boosted given the global backdrop but the medium-term growth potential is likely to be raised as the government gradually moves ahead on a number of fronts. The focus is likely to be across further reforms in key areas aimed at efficiency and raising productivity across both the public and private sectors. A number of commentators have focussed on four areas:

- Land auction reform making auctions far more transparent
- Regulatory changes in the labour market creating more jobs
- Pressing ahead with privatisation
- Measures to boost industry and exports.

In the next few months the Central Bank will also continue to ease policy as inflation remains under control and potentially in response to a stronger currency, as the Fed embarks on rate cuts. The Reserve Bank of India (RBI) has turned dovish and should reduce interest rates by a further 0.50% over the next quarter. In addition it is likely to take measures to reduce credit constraints and improve liquidity across the bond market.

The economic growth projection for 2019 has been lowered marginally to 6.8%, despite the global economic slow-down, due largely to looser domestic monetary and fiscal policies. Looking ahead, growth is likely to edge above 7%.

The trade issue has added to the general woes within the domestic economy

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

THE WORLD AT A GLANCE

Canada

- Growth downgrade to c.1.25%
- Bank of Canada on hold at present but monetary policy is set to become looser

US

- A dovish tilt by the Fed sets the scene for rate cuts this year
- Persistently low inflation proving to be a key concern for the Fed
- Record breaking growth phase to be extended into 2020

UK

- Will a new Prime Minister lead to a better outcome? The economy and markets wait
- Further fiscal loosening seems to be on the cards
- Consumer demand remains relatively strong but this is the only good news

Eurozone

- The ECB sets the stage for significant monetary loosening
- Persistent inflation undershoot proving worrisome

Emerging Markets

- Emerging Markets (EM) contagion fears are less pronounced but growth has weakened
- Chinese policy support in response to slowing growth
- The re-elected PM Modi to use a reform agenda and monetary policy to boost growth

LONDONANDCAPITAL.COM

FIXED INCOME
GOVERNMENT BONDS

London & Capital actions

- **Longer duration to remain in place through the next quarter**
- **Higher government bond allocation to be retained**

Rationale

Duration* in London & Capital Asset Management portfolios was raised continuously over the past six months as evidence of slower economic growth and lower inflation mounted. We had expected this change in underlying economic fundamentals to be the catalyst for a shift in monetary policy. This change has now arrived, but the speed of change in tone by the US Fed and the ECB has been a bit of a surprise as both seem to be lining up rate cuts in the third quarter of this year. This shift in emphasis has provided further support to government bonds, resulting in benchmark 10-year yields plummeting across the board; US 10-years fell below 2.0%, Bunds are in record negative territory and Gilts are approaching 0.75%. Investor positioning and continued economic and political uncertainty may yet push yields lower but this time with steeper yield curves as the short end prices in lower official rates.

We posed ourselves a key question last quarter: How low could yields go? Clearly, we do not face the financial crisis that haunted policy-makers post 2008. Our conclusion was that, given the economic and policy backdrop, the conditions were in place for a further significant drop in yields as the economic challenges were mounting. In such an environment, we indicated that it would be reasonable to expect yields to fall further across major markets and they may well test historic lows, particularly in Europe. (Q2 Macro Outlook)

*Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates

But what now?

Clearly the pace at which sovereign yields have dropped would suggest that there may now be a period of stability, but the ongoing uncertainties around longer-term trade policy, Brexit, political instability, lack of policy consensus in the Eurozone and the onset of the US Presidential cycle (to list some key issues) all adds to ongoing concerns and support for government bonds.

However, what concerns us even more is the possibility of this renewed phase of monetary loosening ultimately failing to either boost growth or raise inflation expectations on a sustainable basis. Of course, there may be short periods of respite when it may appear that growth and prices are picking up, and this will inevitably lead to bouts of elevated volatility in government bonds. The main bone of contention for us is how the economies will move to a higher growth plane with higher inflation unless there is a dramatic shift in momentum in either productivity and/or capital expenditure. Unemployment rates are already at low levels, and to take the US as an example it will require either the labour participation rate to rise markedly, immigration levels to be raised or of course a combination of the two to raise potential output growth. It is possible but it requires the politicians to make difficult choices. As for businesses, a lower cost of capital in isolation is not sufficient to change the dynamics given the significant uncertainties surrounding global supply chains, trading arrangements and potential currency wars.

We had expected this change in underlying economic fundamentals to be the catalyst for a shift in monetary policy

The main bone of contention for us is how the economies will move to a higher growth plane with higher inflation unless there is a dramatic shift in momentum in either productivity and/or capital expenditure

A long diatribe ends with our economic models suggesting further sharp drops in yields remain on the cards, but with an added warning that the lower we go, the greater the threat of damaging spikes in volatility.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

CORPORATE INVESTMENT GRADE

London & Capital actions

- **The credit quality enhancement across LCAM portfolios over the past six months will continue**
- **Adding selective BBB exposure in deleveraging companies**

Rationale for overweight

Foremost, lower government bond yields will drive corporate bond yields lower. Additional supportive factors include:

- slowing growth, but no recession
- reasonable corporate leverage and interest cover
- good cash flow
- high cash balances
- relatively low refinancing risks

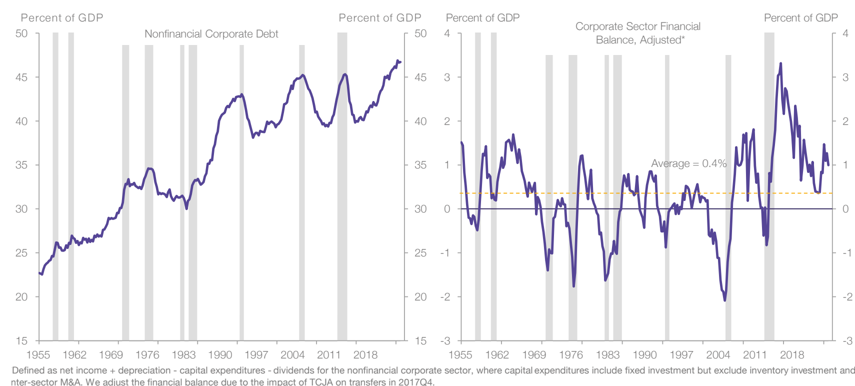
These are all supportive of higher grade corporate bonds (A-AA). Despite fears of rising corporate leverage and potential refinancing risks, it is important to stress that generally higher rated companies have been actively prolonging the maturity of their outstanding debt. The net supply of corporate bonds is set to fall by almost a third in 2019, and clearly lower bond yields will further lower the risk of refinancing.

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 levels have increased to c.48% of GDP, well above previous peaks.

LONDONANDCAPITAL.COM

What follows is a reprint of last quarter's analysis as it remains wholly relevant. Recent analysis by Goldman Sachs summarises the situation rather well, 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



Source: Goldman Sachs

We are also retaining our selective BBB exposure 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, General Motors, 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. We have managed to lock-in price levels that implied a credit downgrade in some cases. We are looking for further companies who are set to deleverage.

Overall, we will retain our bias to hold higher grade investment grade bonds and limit our BBB exposure as it would not be a surprise if some companies suffer credit downgrades given the size of the BBB universe.

Risks

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 IG bonds have faced a more challenging environment and selectivity will be crucial. We are underweight sectors such as retail, energy and consumer cyclical.

Overall, we will retain our bias to hold higher grade investment grade bonds and limit our BBB exposure as it would not be a surprise if some companies suffer credit downgrades

FINANCIALS STRATEGIC VALUE PLAY – STRATEGIC OVERWEIGHT:

London & Capital actions

- **Strategic overweight has been reduced in AT1* debt; US preference bonds/shares and European CoCo** bonds**

LCAM strategies have been overweight in bank and insurance bonds for almost eight years and we are maintaining a strategic medium-term holding particularly in subordinated bonds. The focus remains on Global Systemically Important Financial Institutions (G-SIFIs), national champions and major insurance companies. There has been a significant bounce back in financial bonds this year as credit spreads have narrowed.

Rationale for overweight:

The detailed LCAM Bank Credit Review (available separately) covers the banking universe within our client portfolios, showing that across the board banks have:

- strong balance sheets
- significant capital buffers
- large liquid asset pools providing a further buffer against market volatility
- diversified funding sources

All of these provide the rationale for our positive slant. We highlighted a number of specific issues last quarter that need to be monitored closely, including the impact of money laundering, possibility of non-calls and European banking merges.

The banks have managed to survive the money laundering scandal in terms of pricing, but it has led to management changes and tightening of regulations. We acknowledge that further allegations may yet emerge and we will remain vigilant. However, as a comfort, we have seen that the bolstering of balance sheets and the greater diversification in funding sources led to greater stability.

The markets have also matured in their response to banks failing to call bonds on the first call date. A number of European banks have issued new AT1 paper as they pre-fund ahead of call dates, particularly Nordea, Santander and Barclays. It is important to note that a non-call does not carry the same stigma as before, as banks in most cases have excess capital. In addition, call dates do not revert to becoming perpetuals but switch to either daily, monthly, quarterly or five years. Therefore, the duration remains constrained. In the case of US bank pref (AT1) issues, a number of banks are either calling partially or are letting bonds continue with little price volatility given the favourable structure (for investors) of these bond securities.

Risks

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 to bear in mind the legal aspects and the fact that prices can drop significantly.

*AT1 debt is subordinated bonds issued by banks as a buffer on its balance sheet to supplement the bank's core capital

**CoCo bonds are Contingent Convertible debt, and fall under AT1

Bolstering of balance sheets and the greater diversification in funding sources led to greater stability

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 elective 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, 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.

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

EM IG AND HY DEBT SELECTIVE OVERWEIGHT:

London & Capital actions

- **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 an overweight holding 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, our selective exposure should shield the portfolio.

LONDONANDCAPITAL.COM

EQUITIES OVERVIEW

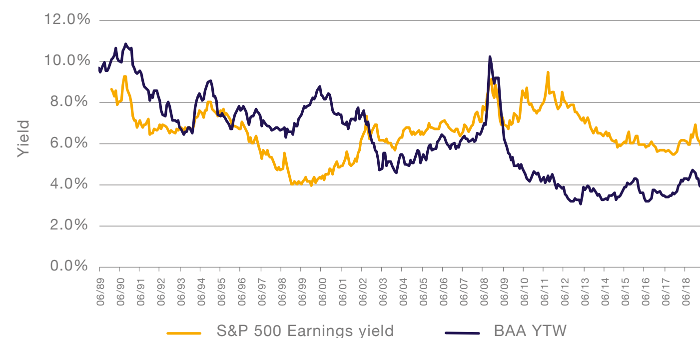
The 2019 equity market rally has continued, with several global market indices moving sharply higher from their low December 2018 base to hit all-time highs.

Essentially, there are two keys dynamics in play for equity markets. The positive factor is an ongoing benefit from the reduction in the cost of capital from falling risk-free rates (government bond yields), and the negative is prospects for deteriorating growth.

Encouragingly, Central Banks appear to be acting more proactively than in previous cycles and have abandoned tightening monetary policy as growth rolls over. However, this environment is a tight rope to walk, and if growth falters significantly then high debt levels and a potential lack of ability to stimulate the economy by monetary measures would result in a nasty shock for equity markets.

The chart below show that equity markets now yield a lot more than Investment Grade bond markets:

Stock market earnings yields compared to corporate bond yields:



Source: London&Capital, Bloomberg Data

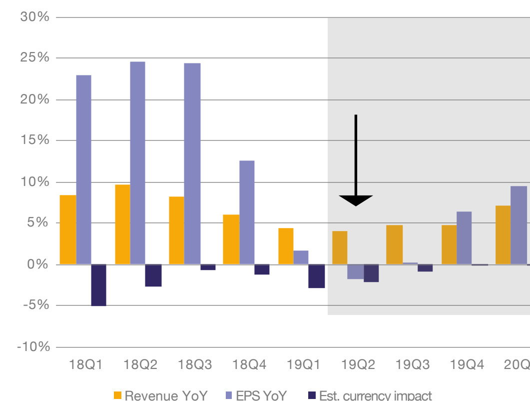
GLOBAL MACRO & MARKET OUTLOOK Q3 2019

However, this valuation comparison only tells half the story in the outlook for equity markets. The other key assessment is the earnings outlook.

The stock market has been quick to re-price equities upwards as the cost of equity has fallen with bond yields, but the assumption behind this upward movement is that growth remains positive and doesn't collapse i.e. the Goldilocks scenario of not too hot and not too cold.

The risk is that the market is too complacent on the outlook for earnings growth. This chart illustrates the outlook:

S&P500 revenue/earnings growth and expectations



Source: London&Capital, Bloomberg Data

The second quarter is expected to represent the nadir in earnings, with a strong recovery expected at the end of the year. The apparent risk is that this might not materialise in a falling growth environment in spite of a comparably easier base relative to 2018.

This could disrupt the market's implied view that bad news is good news (as moderating growth means rate cuts) as the market is now pricing in rate cuts and low growth, but not rate cuts and no/negative growth.

LONDONANDCAPITAL.COM

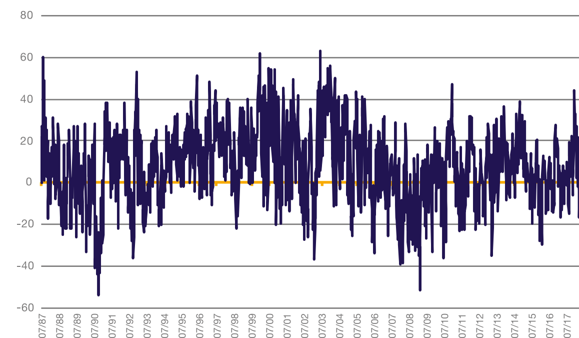
GLOBAL MACRO & MARKET OUTLOOK Q3 2019

Our positioning

London & Capital STAR equities have performed very well in this falling rate and moderating growth environment. In these uncertain times, the focus remains on a combination of defensive and structural growth given the increasingly opaque outlook for the global economy as well as the potential for asymmetric risk in the second half of 2019 (the market's potential to fall is greater than its potential to rise).

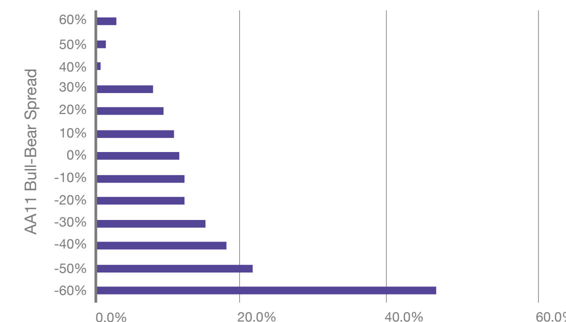
Given an unsupportive environment for growth, we continue to avoid the cyclical sector. The increasing political uncertainty has made investors cautious, which historically has been a contrarian indicator and potentially a big factor behind the year-to-date rally. However, fundamental economic indicators show a lacklustre growth outlook, which means that chasing equity returns now may turn out to be a dangerous trap.

AAII Bull v Bear Investor sentiment spread



Source: London&Capital, Bloomberg Data

Median forward 12m return



Source: London&Capital, Bloomberg Data

The attraction of stable high dividends is the crux of the current London & Capital thematic equity approach; in a low, and falling, interest rate environment there is the potential for significant yield compression (and therefore price appreciation), which has already begun to happen in bond markets. As a consequence, our specialist REIT strategy and UK Income have performed well, and have the potential to continue to do so.

ALTERNATIVES OVERVIEW

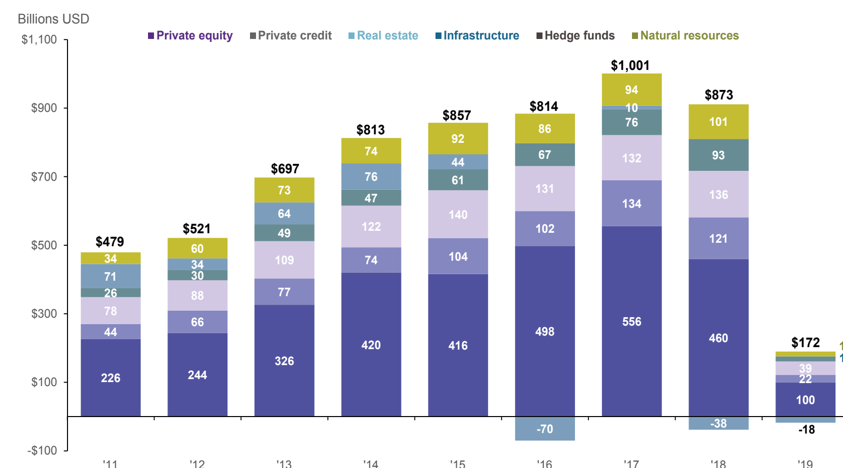
The hedge fund industry continued to benefit from resurgent risk assets in 2019, with second quarter returns making further gains. As many fund managers get sucked into the rally, the inherent level of correlation and beta within the industry is driving returns, and true alpha remains elusive. This means that creating a truly uncorrelated portfolio is all the more difficult. We are of the view that the best approach is a highly selective one, with concentrated manager selection providing diversifying sources of return.

As we edge 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

At the strategy level, directional long-short equity funds have been the strongest performing group of managers, gaining close to 6% returns for the year (according to HFRX). Among event-driven funds, credit and distressed managers have benefitted from a pro-risk stance while merger arbitrage has failed to generate meaningful returns as deal spreads have recently widened (forward-looking expected returns therefore look attractive). Among relative value strategies, arbitrage and multi-strategy funds edged higher. Macro and commodity funds were modestly positive over the period as long exposure to gold and government bonds continued to provide decent hunting ground, although there is now an implicit risk from a sudden reversal of these trends.

Industry assets continue to consolidate, according to data from HFR, as disappointment with regards to 2018 performance continues to filter through to allocation decisions and the ongoing elevated rate of fund closures. We also view this as a sign of a maturing industry where the majority of new allocations from institutional investors have now been made. It is now about finessing exposures and rotation across strategy preferences. As we edge 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.

Global private capital fundraising

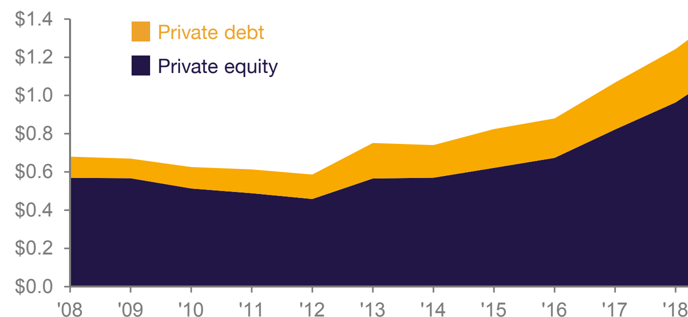


Source: Preqin, HFRI, J.P. Morgan

Flows into broader alternatives allocations have continued to slow into 2019; higher valuations combined with fears of slowing growth may have tempered investor appetite. It may be too early to predict, but flows into private assets could be the lowest for several years in 2019. Nevertheless, we believe the hunt for yield will continue to drive money towards private debt and less correlated real assets in infrastructure and renewables, areas we also favour. In addition, the level of dry powder in private funds remains high, with plenty of capital waiting in the wings to scoop up any cheapening assets.

Global private capital dry powder

Trillions USD



Source: Preqin, Pitchbook, JPM

GLOBAL MACRO & MARKET OUTLOOK Q3 2019

OUR POSITIONING

We are complementing client portfolios with a highly select number of upper quartile liquid hedge fund strategies with a strong, long-term track record of alpha generation. The idea is to provide diversifying sources of return, capturing attractive alpha away from traditional long-only strategies.

London & Capital hedge funds are positioned to be broadly uncorrelated to markets, although 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 have concentrated the exposure in our clients' portfolio of alternatives around a leading equity long-short manager with a growth bias and variable net market exposure. The current defensiveness being applied to portfolio construction means that we believe the strategy can deliver true alpha through volatile or sideways markets, as exhibited in 2018.

London & Capital hedge funds are positioned to be broadly uncorrelated to markets

LONDONANDCAPITAL.COM

Global macro

Macro strategies have the potential to benefit from global macroeconomic policies and the effect these have on rates, fixed income and FX. We are capturing this potential in clients' portfolios through a developed markets strategy with a relative value approach and an EM-focused strategy utilising a combination of debt, rates and FX.

Event-driven

Arbitrage strategies across both hard and soft catalyst event-driven plays are enjoying a rich opportunity set and some complex situations. This provides for added alpha, as well as volatility, providing good trading opportunities. A recent widening of M&A deal spreads gives us a positive outlook for the strategy going forward.

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 such as genetics, as well as a digital freelancing and a credit-scoring platform. We prefer this over a scattergun approach when valuations are high across the industry.

FX

In our Q1 and Q2 updates we outlined how the conditions for US Dollar weakness against Sterling and other developed market currencies may be emerging after a period of cyclical strength, with structural pressures from fiscal and trade deficits coming back into focus. After a period of US exceptionalism, growth and monetary policy differentials in favour of the US looked set to narrow and there were tentative signs of a change in trend. Additionally, in the UK, downside risks to the Pound were receding, as the probability of a hard disorderly exit from the EU moved lower.

In many respects these scenarios have played out as expected, US economic data has softened and growth momentum has faded. Q2 US GDP growth is tracking c1.5%, notably lower than the 2.2% and 3.2% QoQ realised in Q4 18 and Q1 19 respectively, and leading indicators suggest no rival in the second half of 2019. Economic data has consistently disappointed relative to expectations and whilst weakness has been most obvious in manufacturing, fears of a spill over into non-manufacturing sectors have increased. In response to weaker economic conditions and renewed trade war uncertainties the Fed have completed their monetary policy U-turn. At the start of the year FOMC forecasts indicated two rate hikes in 2019, whereas the most recent updates suggest two rate cuts before year end. The market has moved aggressively to price rate cuts, with Fed fund futures for December-19 climbing 0.2% in Q1 and a further 0.5% in Q2.

Although we did not necessarily believe fading exceptionalism would translate into immediate and significant US Dollar weakness, we have been surprised by how resilient the Dollar has been to these challenges. For instance, despite declining fears of a hard Brexit in Q1 and the improving differentials, the Pound was only briefly an outperformer before US Dollar strength re-emerged. US Dollar support has been a function of two main factors, firstly the re-escalation of the US-China trade disputes in early May and secondly

the synchronised global nature of the slowdown in growth and dovishness of central bank policy. Revisions to growth and policy have been more significant in the US, largely due to the higher base, but as has often been the case in the past; when global conditions deteriorate, the US Dollar benefits from deleveraging and safe haven flows. Although the US advantage has narrowed, it has maintained an advantage and against a backdrop of weakness globally, US assets remain relatively more attractive. Recognising the recent resilience of the Dollar, a persistent change in trend would likely require resolution of the US-China trade dispute and a more aggressive Federal Reserve (i.e. return to QE). A scenario of synchronised global growth upswing would also be Dollar negative, but at present this is a diminishing prospect.

Although we did not necessarily believe fading exceptionalism would translate into immediate and significant US Dollar weakness, we have been surprised by how resilient the Dollar has been to these challenges.

As highlighted earlier in the Developed Markets outlook, the Eurozone is encountering its own problems in the second half of 2019 and entering 2020. This suggests to us that the Euro is not that obvious an alternative to the USD, as despite the prospects for larger rate cuts in the US relative to the Eurozone, it is conceivable the ECB restarts it's Asset Purchase Programme which would have the effect of weighing on the value of the Euro.

The outlook for Sterling remains conditional on Brexit and recent developments have resulted in a downgrading of expectations. Fresh political uncertainty with a change in Prime Minster, European elections results and extended negotiations, not only increase the probability of a hard EU exit, but also leave a cloud over UK economy. Significant Sterling weakness may be limited by already low valuations, but it is difficult to see how a recovery can now take place before the new October Brexit deadline. In light of these developments we have reintroduced a small US Dollar exposure to UK client portfolios.

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).

London and Capital Asset Management Limited

Two Fitzroy Place
8 Mortimer Street
London W1T 3JJ
United Kingdom

T +44 (0)20 7396 3200
F +44 (0)20 7396 3201
E invest@londonandcapital.com
W londonandcapital.com

London and Capital Caribbean Limited

1st Floor, One Welches
Welches, St Thomas
Barbados
BB22025

T (246) 537-4182/3
F +44 (0)20 7396 3201
E invest@londonandcapital.com
W londonandcapital.com

Disclaimer: London and Capital Asset Management 143286, is authorised and regulated by the Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN. This document does not represent primary research; it provides the views of the London & Capital investment team examining the fundamental background, economic outlook and possible effect on asset markets. This document is not an invitation to subscribe and is by way of information only. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. If you are considering investing, you should consult your London & Capital adviser. The views expressed herein are those at the time of publication and are subject to change.
Correct at time of going to press. © London and Capital Asset Management Limited. All rights reserved.

Call us on **+44 (0)207 396 3200**
or visit **londonandcapital.com**

London&Capital