London&Capital

THE JAPANIFICATION OF THE GLOBAL ECONOMY

Global Macro & Market Outlook
Fourth Quarter 2019

PARTNERSHIP INVESTMENT CHOICE PRUDENCE

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

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

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INTRODUCTION

Pau Morilla-Giner
Chief Investment Officer

On the back of the screeching handbrake turn by major Central Banks, financial markets are showing signs of extreme confusion: while equity markets still seems to be in 'insurance policy' mode, bond markets have moved to price in a higher likelihood of recession.

It is most evident in the astounding appetite for the safest of assets: government bonds. In Germany, where figures this week showed that the economy is shrinking, interest rates are negative all the way from overnight deposits to 30 year bonds!) Investors who buy and hold bonds to maturity will make a guaranteed cash loss. In Switzerland negative yields extend all the way to 50 year bonds. Even in indebted and crisis-prone Italy, a 10 year bond gets you only 1.5%. In America the curve is inverted (rates on 10 year bonds are lower than on 3 month bills), a rare occurrence that could be a harbinger of recession.

Angst is evident elsewhere, too:

- Over half of the world's bond markets are trading below the Federal Reserve (Fed) funds rate.
- Gold is at a six-year high. Copper prices, a proxy for industrial health, are down sharply.
- Despite Iran's seizure of oil tankers in the Gulf, oil prices have sunk to $60 a barrel.
- Organisation for Economic Co-operation and Development's (OECD) composite of leading indicators fell in June for the 18th consecutive month (the longest stretch of weakness since the great recession).
- China's auto sales fell again in July (the 5.3% year-on-year decline is the 13th negative reading in the past 14 months).

Fear of a weaker global economy that turns recessionary amid an extended trade shock is challenging the idea that the Fed is set for just a 'mid-cycle adjustment to policy'

The fear of a weaker global economy that turns recessionary amid an extended trade shock is challenging the idea that the Fed is set for just a "mid-cycle adjustment to policy". The latest central bank action will also play a key role in expanding the universe of negative-yielding debt, as investment mandates require managers to buy government bonds. As yields fall, so managers buy more in order to stay balanced versus their respective fixed-income benchmarks. This only expands the tide of negative-yielding debt, and places downward pressure on other global sovereigns with positive yields such as Australia, Canada and the US.

The coming Fed rate cuts will keep the economy ticking for a while, but will do little to reactivate the economy and avoid the upcoming significant slowdown. Even before the Fed did a thing, the yield on the 10 year Notes fell by 1.30%, which helped drag down a gamut of borrowing costs priced off the Treasury curve, but there has been no lift for the auto and housing sector:

- Car sales fell 2.0% in July on top of a 1.3% slump in June (and have now declined in three of the past four months).
- Existing home sales dropped 1.7% in June even with much lower mortgage rates — they have been flat or down in three of the past four months, and have declined by 11% at an annual rate over this time frame.

Conclusion: The private sector in the US has so much debt that lowering the cost of credit will not cause the kind of demand reaction that historical standards suggest.

The main danger is that of a profit recession in the US"

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

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

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

We are heading for a prolonged stagnation, driven as much by political uncertainty as underlying fundamentals"

KEY MACRO RISKS

Here are some of the main risks, and our views:

- The global co-operation that helped resolve the 2008 crisis has dissipated with Trump's fracturing of global multilateral institutions. Nationalist passions have already been stirred and it will not take much to unleash a firestorm.
- The risks of a significant US slow-down 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 and 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.
- 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. More problematic, the quality of today's higher debt balances is worse.
- In Italy an increase in market-unfriendly headlines could result in more market turbulence, undermining investor confidence in the Eurozone.
- As the Brexit 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.

HEADING: SUMMARY OF OUR ASSET VIEWS

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

- Our MACRO monitor is flashing AMBER, as weaker US cyclical growth combines with subdued readings in other Developed Markets. There is risk that the monitor turns to RED by late next year.
- Our FISCAL POLICY monitor is flashing GREEN, as populist fiscal stances spread across the globe.
- 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 the monitors, our current Asset Allocation views can be summarised in the following way:

- CASH - Overweight
  - Higher Cash positions are deserved. 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.

FIXED INCOME - Neutral

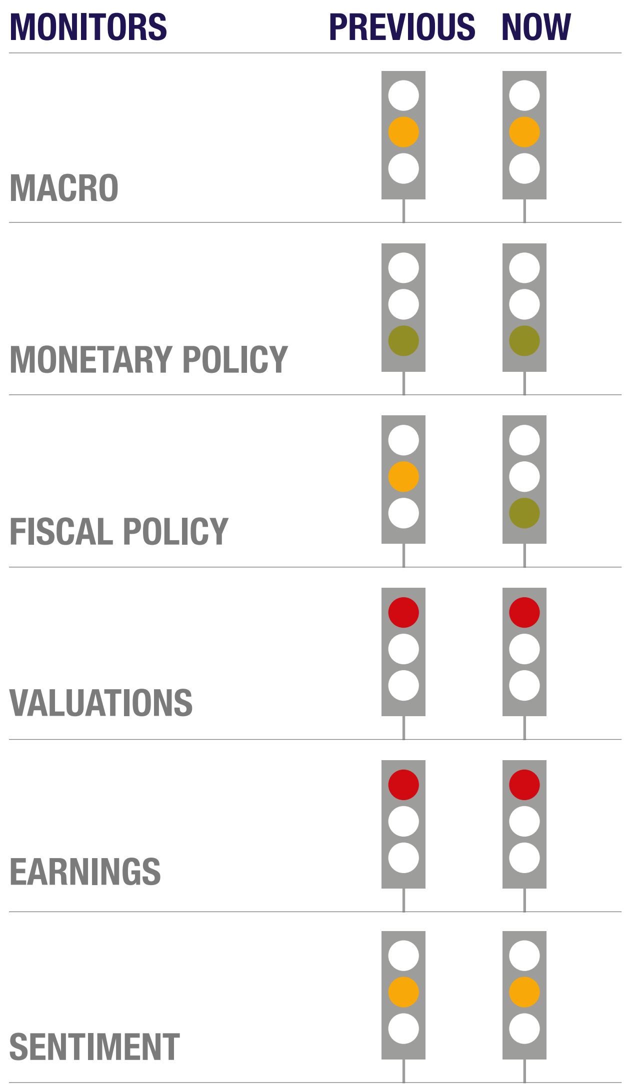
- Reduction in non-financial corporate High Yield allocation, in favour of Investment Grade and higher quality bonds.
- Core exposure to financial bond space still warranted. Within financial bonds, it’s advisable to move down the risk curve.
- While friendlier to bonds than equities, at some point the macro/policy environment will separate good bonds from bad bonds.

EQUITIES – Underweight

- High quality equities well positioned to capture returns in the last innings of the bull market, while being resilient on the way down.

ALTERNATIVES – Neutral

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



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DEVELOPED MARKETS OUTLOOK

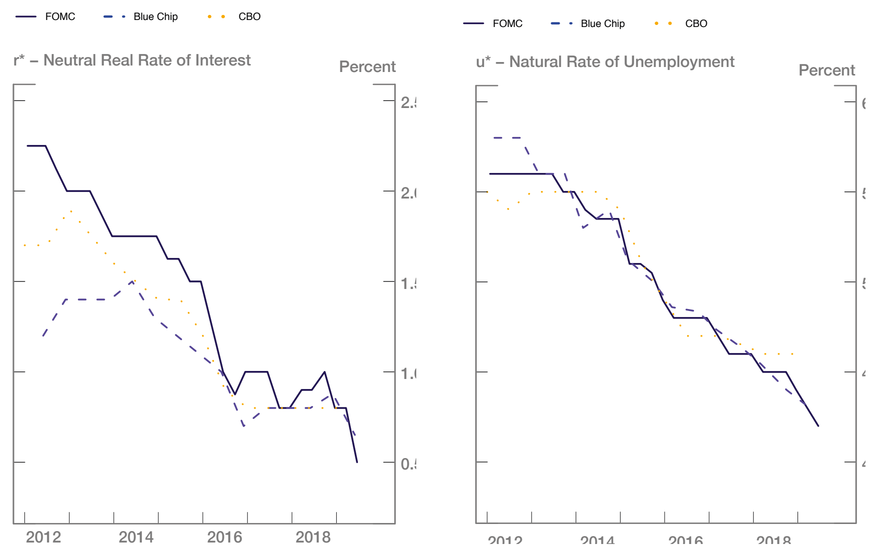
US Economic Outlook

- The Fed remains on a gradual rate cut path
- Persistently low inflation remains a key concern for the Fed
- Recession risk is still relatively low as consumers just keep on spending

The Federal Open Market Committee (FOMC) delivered another 0.25% cut in September following the expected rate cut at their July meeting. The statement, the split rate cut vote and the accompanying forward-looking rate path (the infamous dot plot) sowed some confusion, with Chairman Powell again hinting that the move was "intended to insure against downside risks". The use of the term “insurance” has led to speculation that the Fed may not pursue a long-term easing strategy. Has the Fed really shifted away from their dovish tilt? To some extent they are less dovish than earlier this year, but the direction is still for gradual easing. In fact, the Fed has restated its concerns about slowing growth and its fears that inflation remains below the 2% target. They are rightly looking at a wide swathe of inflation data, including market-based expectations that all point to prices remaining below target for a prolonged period. Our base case for further easing over the next 12 months remains intact given the broadbased global economic slow-down and significant concerns over trade conflicts across multiple fronts. This view is also supported by clues the Fed has given about its longer-term bias in the recent Jackson Hole speech. This maps out the challenges the Fed faces given the continual drop in both the natural rate of unemployment and the neutral real rate of interest, which, combined with persistently low inflation, implies that "interest rates will run, on average, significantly closer to their effective lower bound".

This effective lower bound can be seen as zero rates, as first muted post-financial crash and of course already breached in Europe and Japan.

Real-Time Estimates of real interest rates and natural rate of unemployment



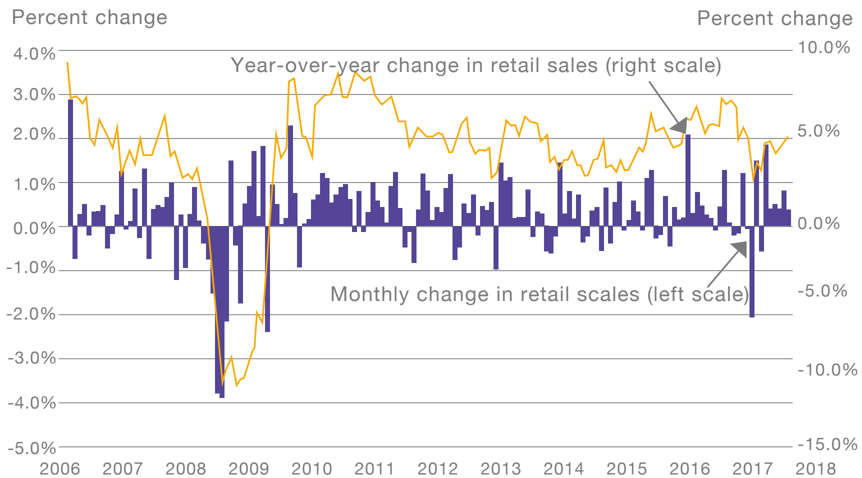
Source: FOMC

Note: The Federal Open Market Committee (FOMC) data are quarterly, extend through June 2019, and are projections of longer–term normal. The Blue Chip data are biannual, extend through June 2019, and are projections for 6 to 10 years in the future. The Congressional Budget Office (CBO) data are biannual and extend through January 2019. For the left panel, the projections are for 10 years in the future; the right panel shows the natural rate projection for the current quarter at the time of the projection. The neutral real interest rate is the 3–month Treasury bill rate projection (CBO) or the federal funds rate projection

We re-iterate our view from the past quarter that the US economy is slowing but the risk of an immediate recession remains low ”

We re-iterate our view from the past quarter that the US economy is slowing but the risk of an immediate recession remains low, even though the Treasury market is signalling a one-in-three chance of a recession. We are about to enter the 124th month of expansion, setting a new record, and the main downside risk is still from the trade conflict damaging global supply chains and creating uncertainty for businesses and consumers alike. The negative consequences are apparent as spending on equipment has ground to a halt whilst investment in structures (i.e. new plants and renovation of older ones) contracted. Business intention surveys remain gloomy. An early trade resolution could be beneficial but a lot will depend on what type of new trading arrangements are in place. Separately, from business spending, the housing market provides little comfort, having contributed negatively for eight out of the past nine quarters. Even with a supportive backdrop it is unlikely to reverse the gradual decline.

Consumers just keep spending



Source: OEF

What is propping up the economy? It's the consumer (accounting for almost 70% of GDP), buoyed by a relatively strong labour market, decent wage growth and higher real income. The risks centre upon job growth slowing and real wage growth being squeezed, but on examining the underlying trends neither are seen as an imminent risk. Nevertheless, history has taught us that a consumer contraction is not a necessary precondition for a recession and we must remain wary of the slowing trends across many sectors within the economy.

Our base case for further easing over the next 12 months remains intact given the broadbased global economic slow-down and significant concerns over trade conflicts

Canada Economic Outlook

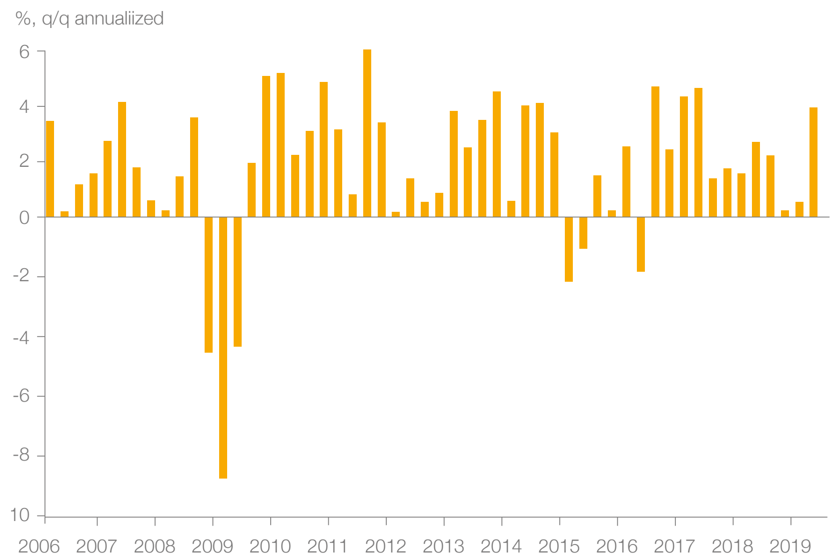
- Growth downgrade to c.1.25%
- Bank of Canada on hold at present but monetary policy is set to become looser

The Bank of Canada (BoC) has kept interest rates on hold through this year, in stark contrast to other major Central Banks as the economy surprised on the upside in the second quarter whilst inflation edged above their 2% target. However, this should not distract from the underlying concerns that are maintaining the dovish bias from earlier in the year. The latest statement from the BoC (September 4th) sums up their dilemma: “Canada’s economy is operating close to potential and inflation is on target. However, escalating trade conflicts and related uncertainty are taking a toll on the global and Canadian economies". We had not expected the BoC to follow the Fed but it will become increasingly difficult for them to ignore the global loosening trend, and it is likely that domestic developments will allow a change in stance and loosening in coming months. The next meeting is scheduled for 30th October, coinciding with an update to official growth and inflation projections; by then they’ll hope to have greater clarity on trade too.

We had not expected the BoC to follow the Fed but it will become increasingly difficult for them to ignore the global loosening trend

The complicated policy backdrop is highlighted by the headline-grabbing 3.7% Q2 GDP growth rate that obviously surprised on the upside. However, closer scrutiny shows that domestic demand actually contracted by 0.7% as consumer spending slowed markedly (just +0.5%) whilst business investment fell a whopping 16.2%, reversing the unexpected Q1 jump. There were two temporary factors that boosted growth in Q2: exports surged over 13% whilst residential investment rose 5.5% after five successive quarterly declines. The export performance is unsustainable given the global growth and trade backdrop, never mind the impact of a stronger currency. Housing is still expected to be a small drag on growth, hampered by tightening bank lending standards and relatively high debt service costs. Both of these underlying forces will continue to act as a constraint for consumers generally. It is a sobering thought for policy-makers in Canada that consumers (unlike their US counterparts) have seen debt levels rise over the past few years in conjunction with rising servicing costs. This is a major risk to longer-term growth expectations that could be accentuated by a breakdown in global trade. There are also considerable risks from a slow-down in employment growth and a resultant squeeze on income.

Canada Real GDP Growth Rates



Source: OEF

The inflation backdrop has been slightly confusing as there was a mid-year rise in the BoC's preferred inflation measures to over 2%. There were some one-off variables that have begun to fade, allowing prices to ease back to target. The pressure for a shift in policy is likely to intensify as inflationary pressures continue to ease, which should allow a 0.25% cut by year-end and further loosening in 2020 as growth moves below potential.

The challenge for the incoming President will be to maintain the consensus and hold the looser stance. Any shift away will be viewed negatively ”

European Economic Outlook

- The ECB unveils a second bazooka – will it succeed?
- Pressure for fiscal loosening intensifies
- Persistent inflation undershoot with sluggish growth seems to be the European norm

The outgoing ECB President Mr. Draghi delivered on his speech in Sintra earlier this year in which he had conceded the need for further monetary loosening, highlighting deepening concern over growth and inflation. The breadth of the ECB Bazooka 2 (first one was in 2012 in the midst of the Euro sovereign debt crisis) was surprising given the public objections from the more conservative northern ECB Council members. The split within the ECB has now been laid bare by fairly swift criticism from Central Bank heads in Germany, Austria, Netherlands and a mild rebuke by France. This disagreement and the call for fiscal policy to step up would suggest that the ECB feels that it is now at or very close to the limits of its policy tools and this has been reflected via a meaningful sell-off in core bond markets after the initial rally. A difficult handover awaits Christine Lagarde.

What did the ECB deliver? It was a multi-faceted package including a rate cut and broader measures.

I. The deposit rate was cut deeper into negative territory, down a further 0.10% to -0.5%. Additionally, forward guidance shifted from calendar-year dependant to inflation-dependant, i.e. "until the inflation outlook converges close to but just below 2%" .

II. QE (asset purchases) will restart at €20 billion per month from November onwards, of which €5 billion will involve corporate bond purchases. However, the 33% sovereign limit was not raised, which places a 9-month limit to QE, but this is likely to be raised by the close of this year.

III. A tiered reserves system will exempt some reserve deposits from negative rates and should help European banks.

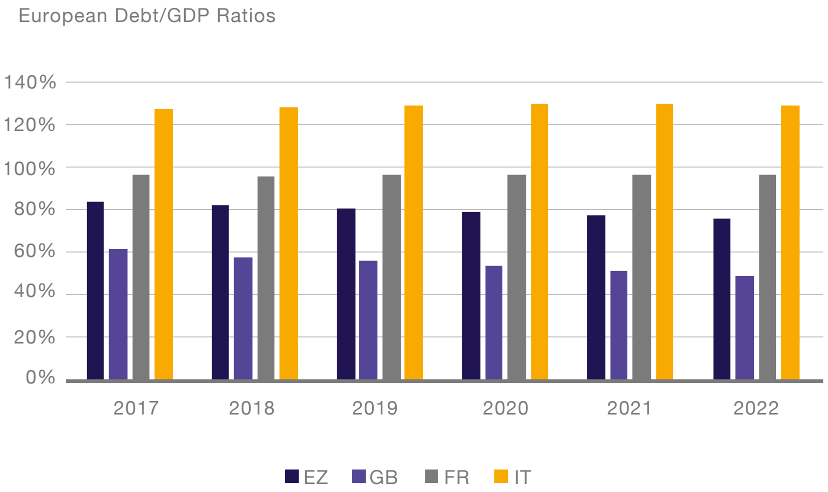
IV. The TLTRO III was lengthened to 3-year maturities whilst removing the 0.10% spread over the deposit rate.

The challenge for the incoming President will be to maintain the consensus and hold the looser stance. Any evidence of a shift away will be viewed negatively. In this context, the economic and price backdrop will clearly be critical. On that basis it is rather difficult to understand why some ECB members object to further monetary loosening unless they wish to see deflation becoming endemic within the Eurozone. The growth projection remains an anaemic 1.25% in 2019 and just 1% next year, with inflation at the lower end of the 1-1.5% range. Apart from consumer demand, almost all other sectors (business investment, industrial sector, exports and housing) are either weakening or are already contracting.

There are now daily calls for fiscal loosening from all across the Euro zone and of course President Draghi also called for affirmative action. On the face of it the budget balance (the Euro zone budget deficit is under 1%) provides plenty of room for manoeuvre. However, this is deceptive as Germany is the one major country with significant room for loosening, with a budget surplus of c.1% of GDP and gross government debt of under 60%

(likely to decline towards 50%). In comparison, both France and Italy have current budget deficits close to 3%, whilst the Spanish deficit is c.2%. The gross debt level In Italy is already above 130% of GDP and is above 90% (but below 100%) in France and Spain. Yes, there is a clarion call for fiscal support but where will it come from and how will it be financed? The conclusion has to be that debt levels will have to rise as governments enact tax cuts and spending increases, and Central Banks will have to finance this through QE to prevent a damaging rise in bond yields. A brave new QE world awaits.

Chart 4: Fiscal Policy – Is there room for manoeuvre?



Source: LCAM/OEF

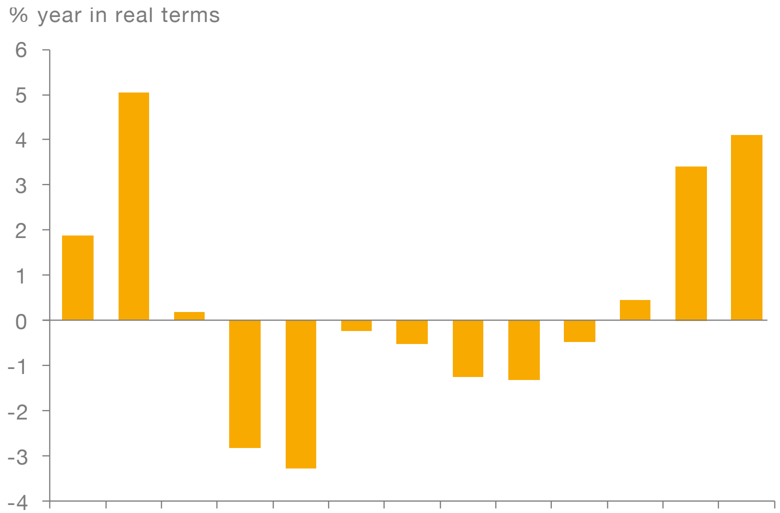
UK Economic Outlook

- Is there life beyond Brexit?
- Austerity ends with a 1-year fiscal giveaway
- Consumer demand remains relatively strong but this is the only good news

A new leader and a new direction – the hope has turned discouragingly into further division (political, social and economic) and we still have no idea whether the UK is exiting on October 31st with or without a deal. Or we may have the drama extended through to January 31st 2020. But in any case, the day of reckoning is near. In the interim we have to decide how to invest in UK financial assets and what type of risks should we take? There are some broad conclusions we can reach: monetary policy will remain supportive for a prolonged period given the significant uncertainties, public spending has been raised by c.£20 billion in 2020/21, growth is below potential and inflation is edging below target.

We are often asked by clients about "project fear" (the post-Brexit economic collapse) as we have escaped the recession that has been predicted for such a long time. We concur and understand that without doubt, the significant support through lower interest rates, higher BoE asset purchases, greater housing support and a significant currency devaluation all helped in keeping recession at bay. Luckily the global growth outlook also improved markedly. An imminent recession is certainly not in sight, but the unbalanced nature of the economy is becoming ever more entrenched. External and domestic uncertainties are increasing, leading to expectations for muted growth of 1-1.5% but with risks to the downside. Consumers have been the mainstay of growth, 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 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.

UK Year-on-Year Departmental Spending - Loosened



Source: OEF

Away from household spending, confidence levels in manufacturing fell below 50, the lowest level since July 2016, as both external and domestic orders fell at the fastest pace in over four years. The construction Purchasing Managers Index (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. Business investment intentions are at their lowest since 2010 and – rather worryingly – businesses are now stating that the global outlook is as concerning to them as Brexit now.

The new Chancellor announced a significant 4.1% 1-year increase in departmental spending, building on the rise last year. This would represent a big step-up and go some way to reversing the cuts seen over several years. But the secondary impact of declines cannot simply be undone so quickly. The charade of the toing and froing in Parliament continues to interfere with any meaningful implementation of a fiscal boost. What is clear is that, come what may, public spending will rise partly due to generous revisions to borrowing projections by the Office Budget Responsibility (OBR) but also largely due to the shift in political ambitions. With the budget deficit below 2% of GDP there is certainly room for fiscal easing, but we will do well to remember that the debt/GDP ratio is still above 80%.

EMERGING MARKETS OUTLOOK

- EM (Emerging Market) growth is weakening, partially due to ongoing trade conflict
- Chinese policy easing to continue in response to slowing growth
- Indian policy easing underway as growth unexpectedly slows

Our EM economic analysis is driven by an examination of key sovereign risk indicators such as reliance on external debt, foreign direct investment flows, government deficits and debt levels, importance of external sector verses domestic growth and possibility of policy support. This analysis suggests that we should remain selective in our risk apportioning. There is a disparate outlook across EM economies, with countries such as Argentina and Venezuela amongst the most volatile.

Chinese domestic growth has inevitably slowed as confidence has waned and real activity has followed suit

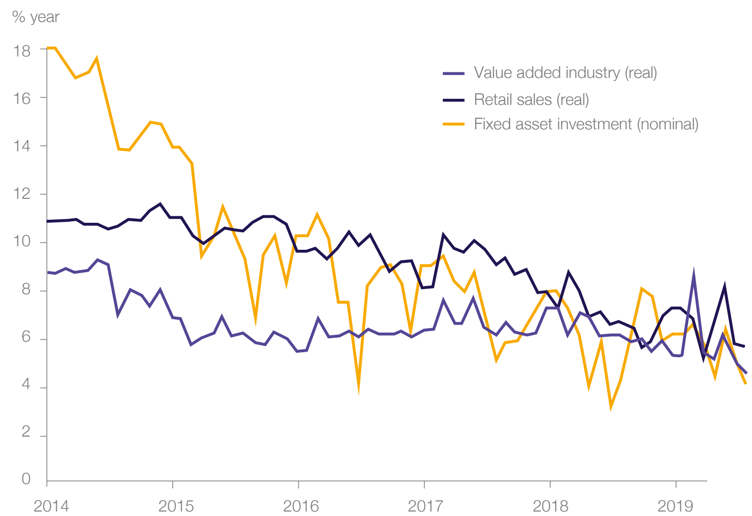
China

The China-US trade saga seems like a long-running soap opera but with one key difference – it matters to the global economy. The thrusts and counterthrusts matter as the two largest economies have managed to undermine global industrial confidence and trade flows. Chinese domestic growth has inevitably slowed as confidence has waned and real activity has followed suit.

The trade issue has added to the general woes within the domestic economy which has seen growth slow to just over 6%. Although this is consistent with the government's own projections, it has led to significant fiscal support and looser monetary policy. Nevertheless, the economy continues to weaken, with manufacturing confidence waning, investment slowing, consumption relatively weak and exports being hit by slowing global demand.

On the fiscal front, the focus has been on tax cuts rather than the normal pump-priming into infrastructure projects. Given the excess capacity in many sectors, it is not surprising that this took the backseat. The tax burden needs to be lowered to accelerate the rebalancing of the economy towards consumer demand. However, it has become apparent that tax cuts are not having the desired impact. It now seems likely that there will be a further dual effort to prop up the economy: greater allowance for provinces to issue bonds to finance infrastructure projects; and additional tax cuts for both consumers and companies. The budget deficit is set to rise to over 6% from 4.7% in 2018, but with the overall government debt level relatively low there is plenty room for manoeuvre.

Key Cyclical Indicators



Source: OEF

On the monetary front, the People's Bank of China (PBoC) has (as expected) been quite aggressive, with multiple cuts in the RRR (Reserve Requirement Ratio) and more easing already hinted at by the State Council. In early September, there was a further blanket cut (0.50% RRR cut) and a targeted cut of 1.00% for some City commercial banks. 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's re-election with a strong mandate for his ruling BJP party has not acted as catalyst for a breakout in growth. To the contrary there was a worrying slow-down in Q2 as GDP growth eased from 5.8% in Q1 to a rather meagre yearly rate of 5%. All major components slowed, with private consumption and investment particular standouts. It is increasingly apparent that the catalogue of changes to reform banking, tighter lending criteria, tax changes and de-monetisation have combined to sap confidence. Of course, most of the changes are of fundamental importance to the long-term health of the economy. In the short-term it is unlikely that 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 for further reforms will be on the on the key areas we highlighted last quarter, aimed at improving efficiency and raising productivity across both the public and private sectors. The changes are gradually being unveiled across four areas: land auction reform, making auctions far more transparent; regulatory changes in the labour market creating more jobs; pressing ahead with privatisation; and measures to boost industry and exports.

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 looser monetary stance is justified as core inflation has eased and is likely to move below the mid-range of the target.

The looser monetary stance is justified as core inflation has eased and is likely to move below the mid-range of the target

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

- The Fed remains on a gradual rate cut path
- Persistently low inflation remains a key concern for the Fed
- Recession risk is still relatively low as consumers just keep on spending

UK

- Is there life beyond Brexit?
- Austerity ends with a 1-year fiscal giveaway
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Europe

- The ECB unveils a second bazooka – will it succeed?
- Pressure for fiscal loosening intensifies
- Persistent inflation undershoot with sluggish growth seems to be the European norm

Emerging Markets

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FIXED INCOME

GOVERNMENT BONDS

London & Capital positioning

- Duration lowered for the first time in a year
- Lower government bond allocation following an overweight position

Portfolio duration was raised at the end of 2018 in anticipation of slower economic growth and lower inflation. We expected this change in underlying economic fundamentals to be the catalyst for a shift in monetary policy, and this has of course now arrived. This shift in emphasis - in tandem with the ongoing trade conflict - has provided significant support to government bonds, resulting in benchmark 10-year bond yields plummeting across the board; US 10-year treasuries fell below 1.5%, German Bunds are in record negative territory and UK Gilts fell to 0.4%. Almost without exception, yield curves have inverted, signalling the increasing probability of recession across the major economies. Historically, inverted yield curves (10-year minus short-end yields) were a sure signal of tougher economic times, but the situation today is complicated by the presence of QE (Central bank asset purchases) pushing longer-dated yields lower artificially and the continuance of the regime of low or even negative interest rates. This may mean that the inversion is more a reflection of slower growth and low rates rather than predictor of recession.

Looking ahead, it may well be that investor positioning coupled with continued economic and political uncertainty may yet push yields lower, but the chance of higher volatility is now more likely, as seen by the sell-off in developed sovereign bond markets post ECB bazooka 2. Further yield drops are still likely, but it is better to be more cautious on duration going forward, largely due to the extended nature of the rally and significant investor positioning, which may well make the market more vulnerable.

It is pretty clear that central bank challenges are mounting, but what does this mean for government bonds as they set the backdrop for all financial assets including equities?

Historically, inverted yield curves were a sure signal of tougher economic times, but the situation today is complicated by the presence of QE

"

This year's Jackson Hole symposium focussed on the challenges faced by Central Banks a decade on from the great financial crash. A few of the key points raised by Chairman Jerome Powell have already been mentioned in the US Outlook with regard to the lower natural rate of unemployment and the falling neutral real rate of interest. A paper provided by Alan. M. Taylor and Oscar Jorda highlights the 30-year drop in the neutral interest rate across the major economies that accelerated post-2008. Apart from the secular decline in inflation (actual and expectations), they also point to the continual weakness in GDP growth (i.e. below potential), the desire to impose fiscal austerity and – critically – demographic trends (ageing population) that have suppressed interest rates. It is difficult to argue that any of these long-term trends will be reversed, which implies that interest rates are set to remain at or even fall below what Central Bankers like to term the effective lower bound (ELB).

In this context, it is not surprising that we have the persistence of negative official interest rates and government bond yields. But there remains a significant concern given the renewed phase of monetary loosening, which may yet ultimately fail to either boost growth or raise inflation expectations on a sustainable basis. 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 underlying issue, which will remain in focus, 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.

As a result, fiscal policy will increasingly come into focus, as has already been seen in the US and recently in the UK. The outgoing ECB President, Mr. Draghi, and incoming Christine Lagarde are both looking for a fiscal response in Europe as they feel the ECB's monetary response is reaching its limits. However, our fear is that in the absence of continual Central Bank asset purchases, looser fiscal policy may well exacerbate the underlying economic malaise if bond yields rise significantly, choking off growth and leading to another leg down in inflation expectations. There are no easy options and we revert to the fear that has gripped investors for years, which is that the developed economies will inevitably mimic Japan, with ever lower interest rates, low growth and low inflation (the new norm).

Clearly the pace at which sovereign yields have dropped would suggest that there may be a period of stability now, 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 add to ongoing concerns and support for government bonds.

It may appear that growth and prices are picking up, and this will inevitably lead to bouts of elevated volatility "

CORPORATE INVESTMENT GRADE

London & Capital positioning

- The higher credit quality across LCAM portfolios over the past 9 months is maintained
- Adding selective BBB exposure in deleveraging companies

Rationale for overweight

Lower government bond yields have driven corporate bond yields lower, but credit spreads have also narrowed through the course of the year, reflecting the improving credit fundamentals. Positive factors include sluggish economic growth, supportive corporate leverage and interest cover, good cash flow, high cash balances and low refinancing risks, particularly for higher grade corporate bonds (A-AA).

There continue to be fears in many quarters about rising corporate leverage and potential refinancing risks, but it is important to stress that generally higher-rated companies have been actively prolonging the maturity of their outstanding debt over the past few years. The table below highlights the rise in duration of outstanding US corporate bonds (including the BBB sector).

Benchmark duration rising over time

	September 2019	September 2011
US Corporate Bonds	7.7 years	6.75 years
US BBB Bonds	7.7 years	7.1 years
Multiverse	7.0 years	5.9 years

Multiverse – Global bond market

Source: Bloomberg Barclays Indices

INTRODUCTION
DEVELOPED MARKETS OUTLOOK
EMERGING MARKETS (EM)
FIXED INCOME
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FX

We have seen a wide swathe of companies (including Apple, Microsoft, Kraft-Heinz, Disney, Vodafone and European utilities) carrying out successful liability management exercises involving retiring or reducing shorter-dated maturities and deliberately extending longer at the lower prevailing interest rates. In the background, the net supply of corporate bonds is set to fall next year, following on from the decline this year.

Concerns over refinancing risks merge with wider concerns over the growth of the corporate debt market post-financial crash, as companies took advantage of low rates. As an aside, investors do tend to overlook the fact that one of the reasons for low rates and QE was to provide an incentive for companies to fill the gap left by deleveraging banks and consumers. If companies had also cut back, a prolonged depression may well have been on the cards. As a result, corporate debt levels increased to c.50% of GDP, which is well above previous peaks. The fear for many commentators has been focussed on the impact of higher interest rates, but at least for the next few years this should be less of a concern. Lower rates/ yields are a positive for corporate debt, but this does not mean that all is rosy; a slower economy and lower earnings will still be a threat. Taking into account various factors, we retain the bias towards higher grade corporates, with a focus on strong cash flow companies including regulated industries.

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We are also retaining 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, 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 other 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 that some companies suffer credit downgrades given the size of the BBB universe.

Risks

The primary risk is an abrupt end to the economic expansion, in turn threatening corporate prospects. A damaging rise in credit risk (i.e. a significant 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 remain underweight sectors such as retail, energy and consumer cyclical.

FINANCIALS
STRATEGIC VALUE PLAY - STRATEGIC OVERWEIGHT

London & Capital positioning

- Strategic overweight has been reduced in AT1 debt, US preference shares and European contingent convertible bonds
- Increased exposure to senior bonds

Rationale for overweight

LCAM strategies have been overweight subordinated bank and insurance bonds for almost eight years, and although we are maintaining a strategic medium-term holding, there has been a change to our strategy this year. First, we have the reduced the significant overweight allocation to subordinated bonds. Second, we have switched to senior TLAC (total loss absorbing capacity bonds). Our focus on the G-SIFIs (global systemically important financial institutions), national champions and major insurance companies remains in place.

We are maintaining a strategic medium-term holding but there has been a change to our strategy this year ”

The detailed LCAM Bank Credit Review (available separately) covers the banking universe within LCAM 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 and diversified funding sources. All of these provide the rationale for our positive slant.

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 has 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 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 perpetual but switch to either daily, monthly, quarterly or 5-years. Therefore, the duration remains constrained. In the case of US bank preference (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

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

CORPORATE HIGH YIELD – SELECTIVE AND UNDERWEIGHT

London & Capital positioning

- Strategic underweight in high yield, given valuations and risk of recession
- Selective exposure in sectors with improving credit metrics

Rationale for selective positions

Generically the high yield sector is still supported by reasonable leverage and interest cover, high cash balances and relatively low refinancing risks. Clearly this does not mean that a scatter gun approach can be taken to allocation, as detailed due diligence on sectors and individual credits are still vital. We have taken an overweight position within hybrid bonds issued by utilities and global corporates. These hybrids have call dates and generally coupon step-ups in the event of a non-call which is clearly advantageous for investors. However, a non-call is also less likely as these instruments would subsequently carry a 100% credit weighting, leading to an increase in leverage and providing a fairly strong incentive for issuers to call. As these bonds are subordinated to senior bonds, they provide higher yields.

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 INVESTMENT GRADE AND HIGH YIELD DEBT – SELECTIVE OVERWEIGHT

London & Capital positioning

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

Clients' portfolios have benefitted from the selective approach to EM debt with the overweight in India and China. We expect to 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.

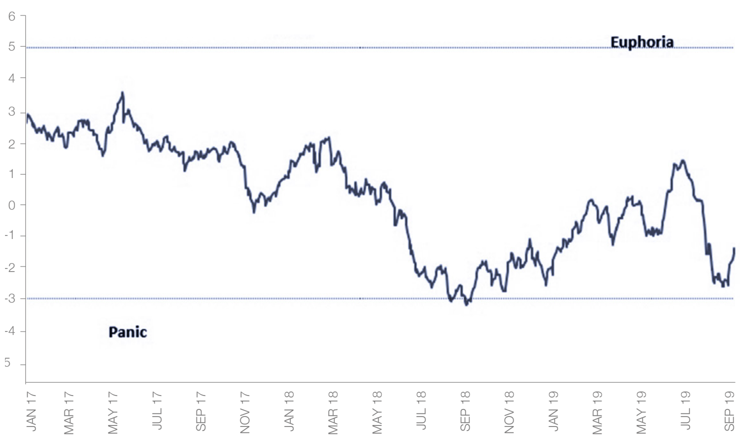
Internal growth dynamics in China and India look reasonable and credit dynamics are supportive

EQUITIES OUTLOOK

After a very strong first half of 2019, from a depressed December 2018 level, equity markets have moved in a sideways direction during the third quarter. Stock market volatility has risen again. After the future expected benefits from reductions in interest rates were factored into asset prices in the second quarter of 2019, trade uncertainties coupled with a weakening economic environment are now causing more angst for investors.

Currently, cautious positioning and crowding out of bonds (given low yields) have reinvigorated equity markets.

Global risk appetite

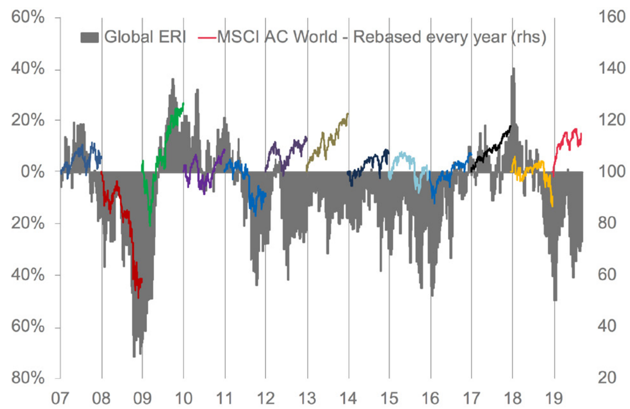


Source: Credit Suisse

However, sustainability of equity market performance over the next 12 months will be determined by earnings. The market is assuming that, after virtually no earnings growth in the first half of 2019, the second half of the year will show a return to growth.

The chart below shows the movement in earnings expectations alongside the move in global equities.

ERI Equity performance



Source: Citi (ERI = Earnings Revision Index)

Two key observations are noteworthy. First, market returns are historically positively correlated with the move in earnings expectations; and second, the current rise in markets but fall in expectations is peculiar.

This anomaly is unlikely to persist. Earnings need to improve or the global stock market will become very vulnerable.

Currently, cautious positioning and crowding out of bonds have reinvigorated equity markets

Our Positioning

2019 year-to-date has been an excellent period of performance for London & Capital equity solutions.

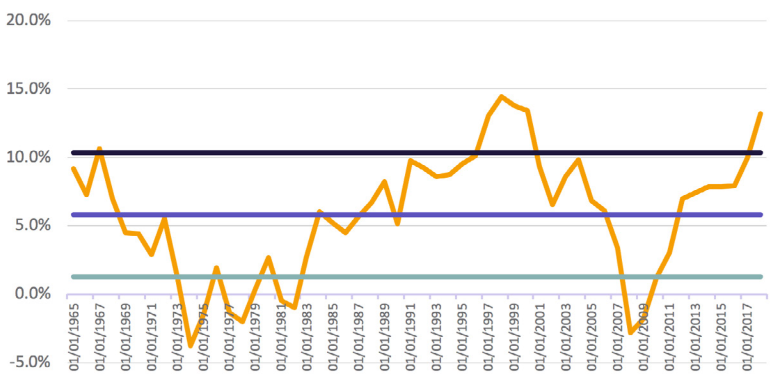
Our view remains that the reward for taking equity market risk is not attractive enough currently, and defensive, high-quality, equity income remains an attractive safe haven in a challenging equity market backdrop.

In fact, the warning signs for equities are flashing – "caution".

FACTOR	ASSESSMENT
INTEREST RATE CYCLE	DANGER!
CYCLE MATURITY	DANGER!
VALUATION	DANGER!
MEAN REVERSION	DANGER!
SENTIMENT	UNCLEAR

Perhaps the most concerning dynamic is the risk of mean reversion in equity returns - based on ten year excess returns. The S&P 500 has only once delivered excess ten year returns above the current level, and that was during the dot-com boom in the late 1990s.

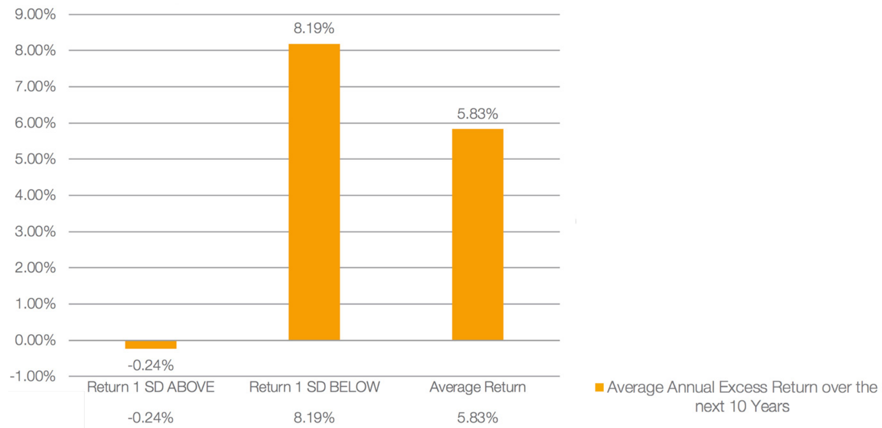
S&P Total Returns Above Base Rates



Source – L&C, Bloomberg Data

The problem is that returns tend to revert; and given the abnormally high level of returns over the last ten years, the prognosis for equity returns over the next ten years is not good.

S&P Total Returns Above Base Rates



Source – L&C, Bloomberg Data

The graph shows that, when the excess return of equities (over base interest rates) has exceeded more than 1 standard deviation* above their long-term average, the returns over the next 10 years have averaged -0.24% per annum. By contrast, when equities' excess return has fallen more than one standard deviation below their long-term average, the average return over the next ten years was 8.19% per annum.

Until the risks reduce and/or the expected equity returns look more attractive, our strategy will be to remain cautious on equities. For our clients' portfolios we are maintaining a low asset allocation weighting, focusing on high quality equities with strong financial metrics and dividends that are both above market average and growing.

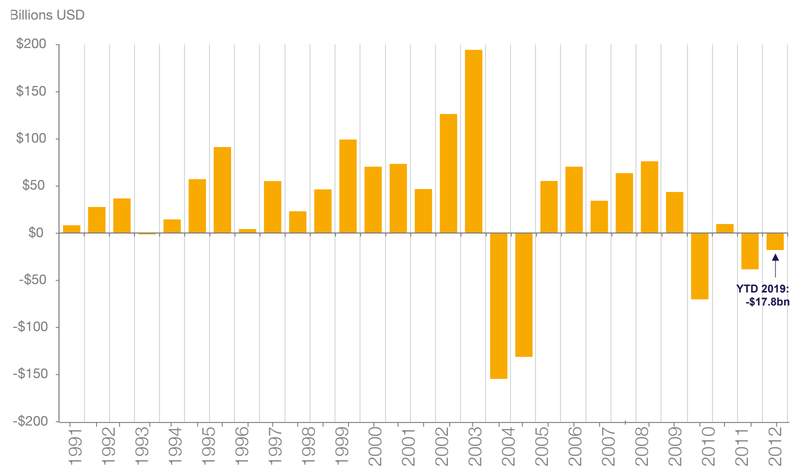
ALTERNATIVE INVESTMENTS OVERVIEW

With traditional assets remaining near their highs, the hedge fund industry has continued to benefit by running with positive levels of correlation and beta to overall markets. An interesting differentiator over the summer was seen in Macro/CTA (commodity trading) strategies, which captured the significant rallies seen in global bonds and gold as well as the downward trend in Pound Sterling. This exposure provided good diversification benefits in August against equity market volatility. However, after five years of disappointing returns from trend-following strategies, we doubt the extent to which this has featured in hedge fund investor portfolios. The extended nature of such trends (as well as equity funds' exposure to factor risks such as growth and momentum) meant that the sell-off in rates and the equity market rotation has made life difficult for some strategies in September.

At the strategy level, directional long-short equity funds have been the strongest performing group of managers, gaining close to 7.5% 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 is reported as being slightly negative for the year (contrary to the steady returns we have seen from our M&A-focused fund). Among relative value strategies, arbitrage and multi-strategy funds edged higher. As mentioned above, trend-following has been the strongest strategy for 2019, but volatility of returns has increased of late and we would be wary of adding exposure at this point. We remain of the view that the best approach is a highly selective one leading to concentrated manager selection, providing diversifying sources of return.

Industry assets continue to consolidate, according to data from HFR, as the huge wave of institutional investment over the last ten years has plateaued. An interesting development over the past few months has been the growth of passive trackers into the industry, as it seems nothing is out of bounds when it comes to wrapping up investments into diversified products with little discernment between underlying constituents or enough (in our view) consideration for the liquidity implications. The recent launch from Aberdeen Standard Investments (partnered with HFR) of a monthly tracker of 500 underlying funds follows hot on the heels of a ASI UCITS hedge fund tracker launched earlier this year, which has already raised $650 million, investing in 180 strategies. It remains to be seen if such passive exposure will deliver the required exposure and diversification when it counts.

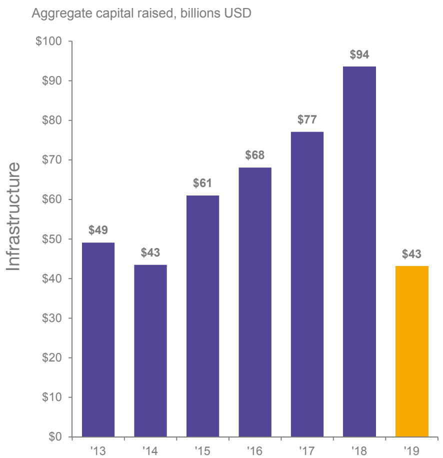
Hedge fund net asset flow



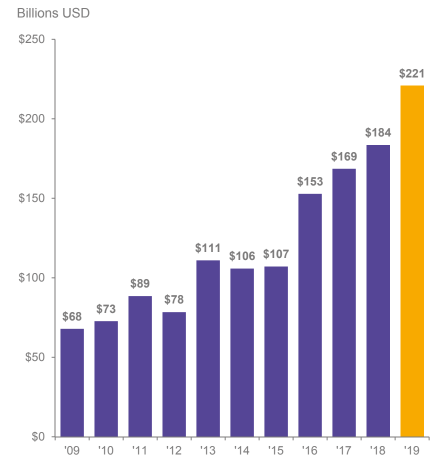
Source: HFRI, J.P. Morgan

Flows into broader Alternatives have picked up following a slow start to the year, but it still looks as though higher valuations combined with fears of slowing growth may have tempered investor appetite somewhat. Flows into private assets for the year could be the lowest since 2014/15. 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. The charts below indicate that demand for infrastructure assets remain robust (figures to mid-year) and significant capital remains on the side-lines, waiting to be invested.

Global infrastructure fundraising



Global infrastructure dry powder*



Source: Preqin, J.P. Morgan

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 alphas away from traditional long-only strategies.

> **To provide diversifying sources of return, capturing attractive alphas 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 strategies: We have concentrated our exposure 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. This was reflected by a decent return during the volatile month of August, although the recent rotation away from growth equities has been a more difficult environment for the strategy.

- Global macro strategies: Macro strategies have the potential to benefit from global macroeconomic policies and the effect these have on rates, fixed income and FX. We are expressing this 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, which 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, and our fund manager of choice has been taking advantage of the backdrop to add positions.

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, and we are analysing new opportunities in royalty stream income.

In Private Equity we have introduced a select number of idiosyncratic funds and direct investments involved in disruptive areas such as tech, biotech and longevity. We prefer this over a scattergun approach when valuations are high across the industry.

FX

The US Dollar made broad gains through the third quarter, supported by a summer of geopolitical and economic uncertainties that dampened the global risk environment. Although the US Federal Reserve cut rates for the first time in ten years, it was against a backdrop of most other developed market central banks threatening to take similar or more aggressive action. Therefore the Fed decision did little to test the resilience of the Dollar. The US maintains its rate advantage and still enjoys relatively stronger economic conditions, with growth in the rest of the world decelerating at a faster pace. For investors this has made US assets and the Dollar the default “least dirty shirt” versus the UK, Europe and Japan. In addition, there is also growing evidence Dollar strength is at least partially owed to tighter liquidity conditions on the back of the widening US fiscal deficit.

In the short-term the direction and volatility of Sterling is conditional on Brexit developments. Boris Johnson’s initial policy approach and temporary suspension of Parliament raised the odds of a hard exit. However, following a series of defeats in Parliament and legislation to force an extension, the probability implied by bookmaker odds of Brexit without a withdrawal agreement this year has fallen back to c.20%. In our view this is too low and should be closer to 40% given the high degree of uncertainty and the persuasions of the UK government. In the short term, our belief is Sterling will move lower from present levels versus the US

Dollar strength is at least partially owed to tighter liquidity conditions on the back of the widening US fiscal deficit

Dollar, with the Brexit risk premium rising in the coming weeks and the possibility of a general election increasing. Concurrently, the US Dollar should stay supported by a cautious global risk environment and the relative growth and yield advantage. However, our expectation of further downside is tempered by the significant short market position accumulated in Sterling, plus the already historically low valuation, which opens the risk of a sharp move higher if we do see Sterling-friendly news flow.

Over the medium-term, once the Brexit process is concluded, the prospects for Sterling could materially improve. Clearly the type of Brexit will determine the strength and resilience of any relief rally, because it will shape immediate economic and policy conditions, but for many investors any resolution regardless of the outcome will be viewed as the point at which the worst for Sterling is over and therefore a strategic opportunity for international investors to buy UK assets. If investment flows into the UK are sufficiently unlocked, it could lead to a meaningful strengthening in the Pound into 2020.

The outlook for the Euro, particularly against the US Dollar, remains challenging. Growth and inflation expectations for the Euro Wzone over the next 18 months have already been revised significantly lower, and with ongoing risks to the downside. In order to offset these trends, the ECB has re-started its asset purchase programme and taken rates to -0.5%, which should keep pressure on the Euro through the remainder of 2019.

If investment flows into the UK are sufficiently unlocked, it could lead to a meaningful strengthening in the Pound into 2020 ”

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 excepti onalism, 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. Second quarter US GDP growth is tracking c.1.5%, notably lower than the 2.2% and 3.2% quarter-on -quarter realised in Q4 2018 and Q1 2019, and leading indicators suggest no rival in the second half of the year. 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 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, Federal Open Market Committee (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 (a measure of the market's expectations for the Fed funds rate) for December 2019 climbing 0.2% in the first quarter and a further 0.5% in the second.

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 the first quarter this year 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: first, the re-escalation of the US-China trade disputes in early May; and second, 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; 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.

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.

A scenario of synchronised global growth upswing would also be Dollar negative, but at present this is a diminishing prospect

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About London & Capital

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

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

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

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

London&Capital