London&Capital

20/20 END OF CYCLE POSTPONED, BUT VISION FAR FROM PERFECT

Global Macro & Market Outlook
First Quarter 2020

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

2019 will be remembered as the year when major central banks staged a significant turnaround in monetary stance. The easing was precipitated by the US Federal Reserve's (Fed) dovish pivot in January, and since then we have seen both the Fed and European Central Bank (ECB) loosening financial conditions. Indeed, 2019 has seen the largest amount of central bank easing since the 2008 financial crisis.

On the back of this, investors have begun to show signs of an acute case of FOMO (fear of missing out) and put cash to work in a way that has not been seen for many years. Some fund manager surveys show that cash levels are now at their lowest in six years.

While central banks' accommodative monetary stances will keep animal spirits high in the short term, the implications for the medium and longer term are more sobering.

Over the medium term, it will limit central banks' ability to 'fight' any recessions further down the line. It will also keep fuelling wealth inequality and exacerbate the current wave of populism across the political arena

Pau Morilla-Giner

Chief Investment Officer

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KEY MACRO RISKS

Here are the main risks we have identified, and our view on these:

- Central banks resume hiking interest rates if they believe the growth risks have passed and inflation pressures are building (high impact, low probability).
- A re-escalation in the trade war that delivers a massive blow to global business confidence, investment spending and global supply chains (high impact, medium probability).
- Victory of a progressive Democrat, such as Senator Warren or Bernie Sanders, in US presidential elections, triggering a negative policy shift for corporate profits (medium impact, low probability).
- Other geopolitical risks, such as an escalation of Hong Kong unrest - which would trigger an aggressive China response and subsequent global sanctions on China - or actions by Iran that threaten global oil supply (medium impact, medium probability).

GLOBAL MACRO & MARKET OUTLOOK Q1 2020

SUMMARY OF OUR MONITOR 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.
- EARNINGS monitor 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.
- VALUATION monitor has been in RED for a few quarters now: after years of financial repression, few listed assets are below historical averages.
- SENTIMENT monitor is in AMBER: there is still plenty of cash on the side-lines – which is a bullish indicator - but the start of the year rally is bound to lose momentum.

GLOBAL MACRO & MARKET OUTLOOK Q1 2020

SUMMARY OF OUR ASSET VIEWS

Cash Overweight

Higher cash positions are merited.

A portion of this cash should be in gold. Gold has correctly anticipated the powerful shift in central bank monetary policy regimes. Although continued near-term volatility in gold is possible, given the rapid surge in the Fed's balance sheet (the Fed has undone seven months of quantitative tightening in the past seven weeks and is now expanding its balance sheet), long-term investors should continue to accumulate gold as a hedge in their portfolios.

In a world where the Fed is prepared to implement 'yield curve control' and will refrain from raising rates unless 'a really significant move up in inflation that's persistent', gold could become one of the strongest assets in the world.

Fixed Income Neutral

There is little doubt as to how far the Fed is willing to go to keep interest rates from rising.

This was the view of Fed Chair Powell in June:

"Perhaps it is time to retire the term 'unconventional' when referring to tools used in the crisis. We know that tools like these are likely to be needed in some form in [the] future. Also, we have discussed targeting longer-term interest rates as a new tool to combat the next recession and a symmetrical inflation target."

Translation: "We are considering printing helicopter money while anchoring long-rates to avoid a dangerous market signal and higher interest rates in a weak economy."

Allowing inflation to 'run hot' and targeting - a great euphemism for 'capping' – interest rates will result in a lengthy period of negative real yields. This will lead to lessening the real, inflation-adjusted burden of debt.

Lower for longer rates are good for credit, at least in the short term. Having said this, one should focus on two main areas:

- Sectors where leverage has not increased significantly (financials mainly)
- Corporates where their earnings are not too cyclical/volatile (earnings are under threat in a low-growth economic environment)

Equities Underweight

Equities have the potential to continue performing well in the short term, as central banks keep pumping money and investors are forced up the risk curve.

However, low growth might lead to a 'profit recession', which will hit cyclical equities more, so stick to defensive equities that pay dividends (bond proxies).

We remain slightly underweight global equities overall in our clients' portfolios, with the spill over of manufacturing weakness to consumer spending, US earnings' growth turning negative by Easter 2020, US elections and continued trade tensions as potential sources of volatility.

Overall, in 2020 shareholder returns will be largely driven by dividends and buybacks.

Commodities Underweight

Due to ongoing geopolitical tensions, the risk of oil price spikes remains elevated. Nevertheless, the possibility of a supply overhang will be the main factor for oil markets in 2020. We see Brent crude oil reaching USD 50 by next Spring and anticipate it to remain close to this level for the rest of the year.

Alternatives Neutral

Truly uncorrelated alternative strategies will continue to complement the rest of a well-constructed portfolio.

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DEVELOPED MARKETS OUTLOOK

US ECONOMIC OUTLOOK

- **Fed policy is on hold unless inflation expectations turn lower**
- **Growth to be close to underlying potential, i.e. c.2%**
- **Recession risk has abated as some uncertainties are close to being resolved**

The US Federal Reserve (Fed) unsurprisingly hit the pause button following a third rate cut this year, although it kept the door open to further loosening if necessitated by the underlying economic data. It would seem to be a sensible approach given that the economy is proving to be relatively resilient, i.e. the threat of a recession has faded through the autumn months, although they are continuing to monitor low inflation expectations. The rate cuts were necessary as an insurance policy against the steep deterioration in manufacturing sentiment, the negative implications of the trade conflict with China and Europe, and the continual undershoot in inflation. There is an additional technical issue regarding the repo market[1] that has proved to be a little challenging, leading to successive injections of liquidity particularly near year end. A longer-term fix will need to be implemented even though the repo squeeze is not akin to the closure of money markets during the financial crash. The markets are now not pricing in any rate cuts in 2020, which may prove to be too pessimistic if inflation continues to undershoot and growth eases, given the length of this expansion. Our base case is for rates to remain steady through most of the year, with higher asset purchases being maintained. What will shift our central projection? Primarily a change in inflation driven by a pick-up in economic momentum putting upward pressure on wages.

Growth is expected to remain close to potential in 2020. However, the Boeing 737 Max production cut is a slight complication, with some forecasters (such as OEF) suggesting that it could shave up to 0.5% of growth in the first quarter.

Watch list for 2020:

(1) Consumer spending

Can the consumer (accounting for almost 70% of GDP) continue to prop up the economy? The key support is provided by a relatively strong labour market, decent wage growth and higher real income.

We remain slightly underweight global equities overall in our clients' portfolios

The risks centre upon job growth slowing and real wage growth being squeezed, but on examining the underlying trends neither are seen as imminent risks.

(2) Business investment

Will business investment manage to benefit from some of the uncertainties being resolved? Namely the trade conflict with China, less disruptive global supply chains and a potential resolution to Brexit.

(3) Corporate earnings

Will corporate earnings match the optimism within the broader risk markets? Apart from the importance of earnings for the stock market, clearly it is also necessary to maintain job growth and the ability to increase capital expenditure.

(4) Inflation

Will the persistent undershooting of core inflation finally end? Wage growth will be crucial and our base case is for the labour market to tighten further with skill shortages emerging in key sectors.

[1]A repurchase agreement (repo) is a form of short term borrowing for dealers in government securities. It is seen as a systemically crucial source of funding for banks and some leveraged investors.

EUROPEAN ECONOMIC OUTLOOK

- **The ECB sits on its hands whilst launching a major policy review**
- **Pressure for fiscal loosening intensifies**
- **2020 another year of persistent inflation undershoot with sluggish growth**

Christian Lagarde, the new ECB President, faces a difficult balancing act as she deals with criticism from many quarters of the negative rate policy and the step-up in asset purchases put in place by Mario Draghi. In her first meeting the ECB unsurprisingly maintained the full range of accommodative policies. However, there is an underlying sense that policy is now on hold for a prolonged period despite the ECB's own projections for inflation to remain well below the 2% target. Even the growth projections are hardly inspiring, but it would seem as if the collective criticism of deep negative rates from Central Bank heads in Germany, Austria, Netherlands and a mild rebuke by France is having an impact. Understandably there is concern that negative rates may do more damage than good, although Ms Lagarde was keen to stress that to date the balance is in favour of a positive impact. A major review of policy has been announced and is likely to cover the inflation target (should they move away from the current rather odd 2% or just below target?), market communication, climate change and impact of asset purchases. A quick decision should not be expected. Our base case is for policy to be on hold through 2020, with inflation the key variable that could yet put further pressure on the Central Bank to ease further.

Growth has been weak in 2019 and is expected to remain below potential in 2020, in line with the ECB's projections.

GLOBAL MACRO & MARKET OUTLOOK Q1 2020

Watch list for 2020:

(1) Manufacturing

The steep decline in manufacturing sentiment across the region was stark, led by Germany as it was buffeted by the hit on autos and the slow-down in global trade. There are finally welcome signs of a tentative stabilisation. Clearly it is vital for Europe that the auto industry in Germany retains a firmer footing, even though the tariff threat remains in the background.

(2) Consumer spending

Can consumers stay resilient supported by a relatively strong job market, low inflation and better real wage growth? We will closely monitor consumer spending and confidence levels in the face of persistently low inflation expectations and weak economic sentiment.

(3) Business investment

Business investment was surprisingly strong in 2019, but with large variations across the region. Our central case is for modest gains in 2020 largely due to the base effect (i.e. 2019 was strong). There are still reasons to be positive, with credit conditions supportive and consumers relatively buoyant. The threat of tariffs on autos and potentially other European goods remains ever present in the background.

(4) Fiscal policy

Will fiscal policy be used actively with Germany at the forefront? There are some positive signs that there may be an effort to raise infrastructure spending, but policy moves are generally at a snail's pace in Europe and of course a number of countries do not have the room for manoeuvre.

Our base case is for policy to be on hold through 2020, with inflation the key variable that could yet put further pressure on the Central Bank to ease further.

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UK ECONOMIC OUTLOOK

- **Brexit moving into crucial second stage with a big Tory majority**
- **Austerity is behind us and the BoE will sit on its hands**
- **Consumer demand remains relatively strong but this is the only good news**

A decisive electoral victory for the Conservatives sets the stage for the UK's withdrawal from the EU in January 2020, a pathway to new trade pacts and a boost to vital public services and infrastructure. It has also removed the threat of nationalisation, significant tax hikes and a rapid deterioration in public finances. However, there are still many challenges ahead as the second more difficult phase of trade negotiations will only begin in 2020 with a strict end-December deadline put into law. This has raised the spectre of a potential hard Brexit in the event of trade talks failing. The Bank of England has a difficult task ahead; growth is moderate, inflation is below target and negotiation risks will be high through to mid-year, which in truth is the deadline for the discussions with the EU on the UK's future relationship across trade, services, security and more. At present two members of the monetary policy committee are pressing for a rate cut, and they will be joined by others if the concerns mentioned earlier begin to rise in prominence. Our base case is for rates to remain steady through mid-year. Beyond that it is down to the politicians and the EU. Success and markets will begin to price in mild monetary tightening in 2021. Failure and a rate cut, and asset purchases will return. Despite political stability, the BoE still has economic uncertainty to contend with.

GDP growth in 2019 slowed to c.1.25% and should remain close to this level in 2020. There is as much uncertainty as in Europe due to the obvious concerns over trade in the new post-Brexit world. Low inflation is also a continual issue into 2020.

Watch list for 2020:

(1) Trade negotiations

The EU/UK trade negotiations will need to make significant headway by mid-year. Experts are clear that a major re-writing of rules and engagement with the EU will require all 27 members of the EU having to ratify a new Treaty. Additionally, new trade arrangements must be put into place with other major trading partners. Markets and the BoE will certainly be on their toes.

Despite political stability, the BoE still has economic uncertainty to contend with

(2) Business investment

Businesses have held back from investment and surveys are rather pessimistic. An area that will need a close watch – will businesses respond positively to political stability and not worry about what they face from 2021 onwards? Companies are certainly poised to boost capital spending given the solid balance sheets and high cash balances.

(3) Consumer spending

Will consumers continue to spend? Consumers have been resilient on the back of solid jobs growth, low inflation and higher nominal and real wage growth. There are headwinds ahead such as recent easing in job hiring, a slowing housing market and lower credit take-up.

(4) Fiscal policy

How big will the fiscal boost be in 2020? The plans are ambitious, with higher departmental spending on health, education and the police service. There is also an additional £100 billion to spend on over infrastructure projects over the next five years. The fiscal impulse next year is likely to be around 0.5% and will rise in the years beyond as infrastructure spending begins to take effect.

OTHER G7 ECONOMIC OUTLOOK

Canada:

- **Canada remains in a conundrum**
- **Bank of Canada on hold at present but monetary policy should be looser**

The Bank of Canada (BoC) has remained on hold through this year, in stark contrast to other major Central Banks, as the economy continues to display signs of bi-polarism. However, this should not distract from the underlying concerns that are driving the dovish monetary bias, a change from earlier in the year.

Underlying concerns are driving the dovish monetary bias, a change from earlier in the year ”

Watch list for 2020:

(1) Inflation

Inflation volatile and close to target. Can the Bank of Canada ignore the rise in all key measures of inflation in recent months, in stark contrast to other major economies?

(2) Confidence

Watching for confidence levels to turn up. Growth has slowed from the rather freakish rate in Q2. The Bank of Canada has highlighted various concerns including business investment, trade and consumer demand.

(3) Fiscal policy

Potential for further fiscal loosening given the considerable room for manoeuvre.

Japan:

- **Monetary policy to remain ultra-accommodative, with fiscal loosening implemented**
- **Growth still tepid and inflation remains far too low**

The Bank of Japan kept all of its policy tools in place whilst successfully moving the 10-year yield higher toward 0%. There has been yet another substantial fiscal loosening of over $120 billion. The medicine continues to be dispensed to the economy but growth remains tepid (between 0.5-1.25% annual growth) and inflation around 0.5%.

Watch list for 2020:

(1) Deflation

The persistent deflationary threat continues. Inflation is still below 1% across a broad range of measures. Should the BoJ stop caring about a structural issue and instead focus on faster growth?

(2) Sentiment

Worrying deterioration in the Tankan sentiment, particularly with regard to business investment and export prospects.

The medicine continues to be dispensed to the economy but growth remains tepid ”

(3) Exports

Exports remain under pressure due to weak global trade growth and trade conflicts. Will the better tone finally help lift the gloom and provide support to exports?

(4) BoJ asset purchasing

Can the BoJ afford to trim back on bond and ETF purchases? It’s important to note that both have been trimmed in recent months.

EMERGING MARKETS OUTLOOK

- EM better news on multiple fronts
- Policy easing to continue
- Trade conflict threat may be receding

Monetary policy was loosened across almost all major EM economies as global trade volumes fell and trade friction rose. Unfortunately, vulnerabilities reared their ugly head across parts of Latin America in particular; by contrast, Asia and Africa fared relatively well despite slower growth. However, undoubtedly the end of the year has seen better news on multiple fronts; the trade haze may be clearing, looser monetary policy is entrenched within the developed markets, fiscal loosening is on the agenda across the G7, the USD has weakened in the final quarter and risk appetite is relatively strong. The scene is also set for further monetary and fiscal loosening in the EM block. As always there will continue to be a disparate outlook across EM economies and we will remain extremely selective.

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Watch list for 2020:

(1) China trade deal

China Phase 1 trade deal – can it translate into a decisive trade deal in 2020? The Phase 1 deal has included a roll back in tariffs from 15% to 7.5% for $120 billion of goods, whilst the new tariff threat has been removed. A final sign-off in early January will be a positive step. 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.

(2) Confidence

Away from trade tensions, confidence levels have begun to stabilise. The prospect of a rebound – in tandem with the developed block – is setting the scene for a potential growth upgrade.

(3) Fiscal policy

Fiscal policy was loosened in China in 2019 and further measures may yet be taken irrespective of the trade deal in an effort to prop up growth close to 6%. India is also likely to embark on fiscal support as growth has slowed to below 5%.

(4) Currency

USD weakening will be welcome providing relief across the whole EM block. It is unlikely that the Fed or the US Treasury will deliberately pursue a weak dollar policy but a shift in growth differentials and an easing in trade tensions may well provide the backdrop for EM currency appreciation.

(5) Argentina

Can Argentina somehow find a way forward? Another year another Argentinian default looming. A positive outcome will lift sentiment across the region.

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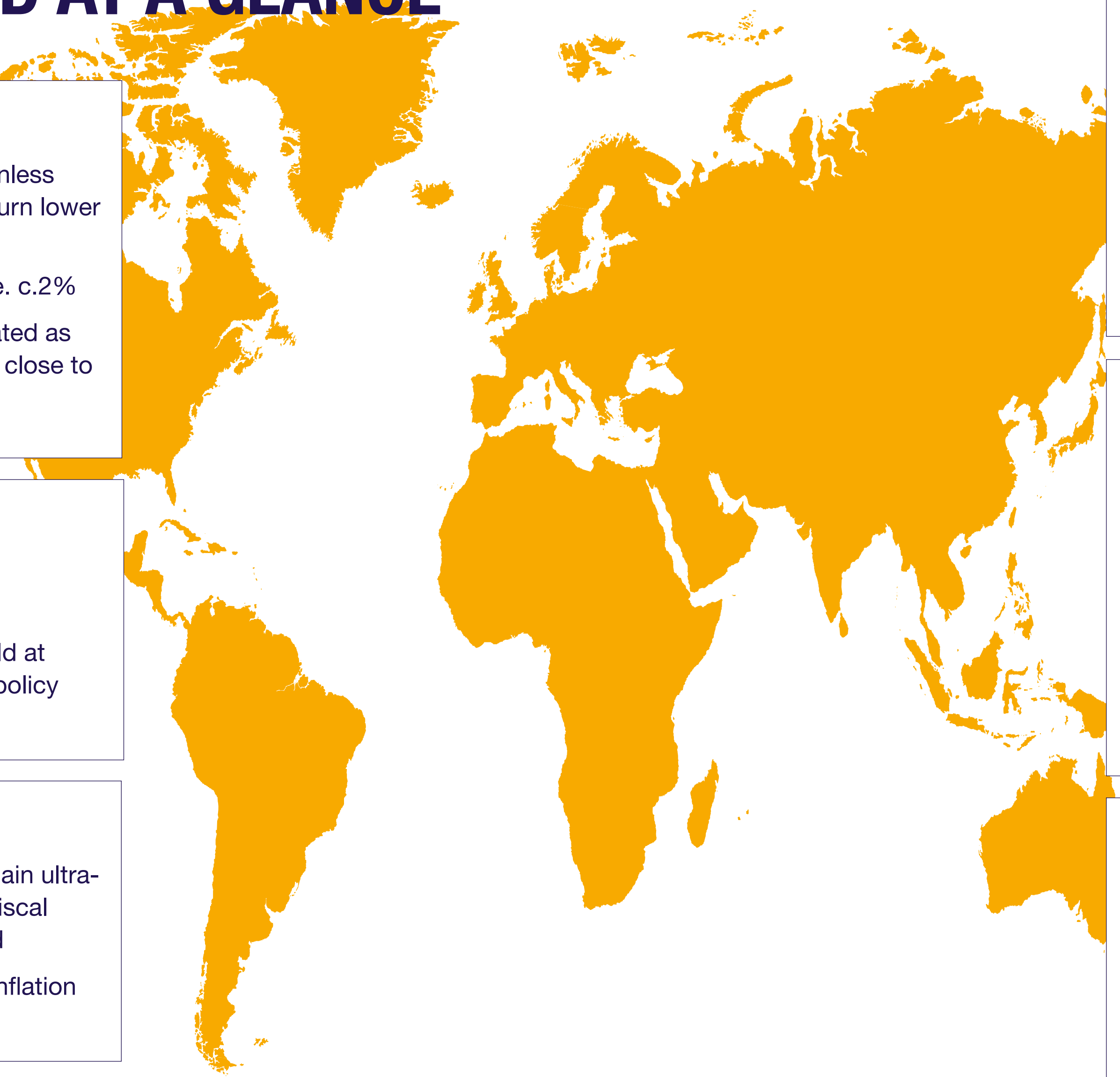
THE WORLD AT A GLANCE



US

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UK

- Brexit moving into crucial second stage with a big Tory majority
- Austerity is behind us and the BoE will sit on its hands
- Consumer demand remains relatively strong but this is the only good news

Europe

- The ECB sits on its hands whilst launching a major policy review
- Pressure for fiscal loosening intensifies
- 2020 another year of persistent inflation undershoot with sluggish growth

Emerging Markets

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- Trade conflict threat may be receding

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FIXED INCOME

GOVERNMENT BONDS:

- **Lower duration due to stretched valuations and stabilising economic conditions**
- **Lower government bond allocation**

The sensitivity to interest rates in our clients' portfolios ("duration") was at an elevated level through late 2018 and most of 2019, but was lowered as we entered the final quarter of 2019. This shift towards lower duration was driven by two factors: first, stretched valuations; and second, signs that that the global economy was beginning to stabilise.

Looking ahead, it may well be that investor positioning coupled with continued economic and political uncertainty will push yields lower, but higher volatility is now more likely, as seen in the sell-off in developed sovereign bond markets in the final quarter of 2019. We are not projecting a significant unwind of the flight to quality that has been apparent over the past 12-18 months, but would not be surprised if there are periods of elevated volatility leading to yield spikes. We will tactically take advantage of such moves but strategically are comfortable with lower duration into 2020.

CORPORATE INVESTMENT GRADE

- **Short-dated higher-rated credits with decent carry to be maintained across portfolios as insurance against global uncertainties**
- **Adding to selective BBB exposure in deleveraging companies**

Rationale for overweight: credit spreads have narrowed through the course of the year, reflecting improving credit fundamentals including successful refinancing as interest rates and bond yields fell. Positive factors include economic growth (albeit moderate), supportive balance sheet leverage and interest cover, good cash flow, high cash balances and low refinancing risks particularly for higher grade corporate bonds (A-AA). However, the expectation of government bond valuations looking more stretched with the potential for damaging volatility spikes through 2020 translates into ensuring that the exposure is to shorter maturities.

The fears over rising corporate leverage and potential refinancing risks will rightly persist, and we would never be complacent about this. It is imperative that our due diligence process weeds out those companies (particularly in the BBB region) that face potential downgrades and therefore refinancing risks. However, 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, reducing short-term refinancing risks. A wide swathe of companies (such as Apple, Microsoft, Kraft-Heinz, Disney, Vodafone and European utilities) have carried out successful liability management exercises involving retiring or reducing shorter-dated maturities and extending longer at the lower market rates. In the background, the net[2] supply of corporate bonds is set to fall next year following on from the decline this year.

[2] The net supply relates to new bond estimate minus maturing/retired issues.

We will retain and add to our selective BBB exposure as 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.

We will retain and add to our selective BBB exposure as global companies undertake significant deleveraging to climb back up the rating scale

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 locked 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 higher grade investment grade bonds and limit our BBB exposure as it would not be a surprise that some companies suffer credit downgrades.

Risks: The primary risk is that the signs of economic stabilisation prove to be a false dawn with the threat of a recession undermining corporate earnings. 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.

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FINANCIALS

Strategic value play - Strategic overweight:

- **Maintaining strategic positions in additional tier-one (AT1) debt; US preferred stocks and European contingent convertible (CoCo) bonds**
- **Senior bond exposure reduced as global economic risks decline**

Rationale for overweight: London & Capital portfolio will continue to hold strategic medium-term positions in subordinated bank and insurance bonds.

Our detailed Bank Credit Review covers the banking universe within London & Capital 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 regulators (and politicians) are in no mood to let up on regulations as we move towards the 2022 Basel 3 deadline.

The banks have also shown remarkable stability in the face of some challenges including the money laundering scandal amongst the Nordics and the "non-call" by Santander of one of their Co-Co bonds. We acknowledge that banks may always be vulnerable to scandals but also appreciate that tightening of regulations means that banks are able to withstand short-term volatility. However, we will need to be vigilant. The markets have also matured in their response to banks failing to call bonds on the first call date. 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, or quarterly or 5-years. Therefore, the duration remains constrained. In the case of US bank preferred (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 principal risk in the financials sector is a significant stock market correction and a worsening in underlying economic conditions, especially for the higher-beta subordinated universe. However, in our judgement these should not be viewed as akin to 2008 or 2010 but rather a source of more normal price volatility. It is also important to note that AT1 debt legally includes capital triggers and coupon deferral language. We have seen banks remaining highly capitalised within the severe bank stress tests carried out by the regulators, but nonetheless it is important in bear in mind the legal aspects and the fact that prices can drop significantly.

CORPORATE HIGH YIELD

Selective and underweight:

- **Strategic underweight in high yield given valuations and refinancing risks**
- **Selective exposure in sectors with improving credit metrics**

Rationale for selective positions: Generically the high yield sector is still supported by reasonable leverage and interest cover, high cash balances and relatively low refinancing risks. Clearly this does not mean that a scatter gun approach can be taken to allocation; detailed due diligence on sectors and individual credits is essential. We have taken an overweight position in our clients' portfolios in 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 which would provide a fairly strong incentive for issuers to call. As these bonds are subordinated to senior bonds they provide higher (and attractive) yields.

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

EM IG AND HY DEBT

Selective overweight:

- **Selective exposure to India, China and Brazil hard currency debt**

London & Capital clients' portfolios have benefitted from the selective approach to EM debt with overweight positions 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.

These hybrids have call dates and generally coupon step-ups in the event of a non-call which is clearly advantageous for investors

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EQUITIES OVERVIEW

2019 saw an incredible move in equity markets with global market indices achieving returns in excess of 20%, albeit from a very depressed 2018 base. The main driver of equity markets – as with all financial assets – has been the Federal Reserve (Fed). The change in monetary policy, which lowered the cost of capital for investors, significantly boosted equity markets.

However, the growth environment was less encouraging. The re-rating of stocks (2019 share price returns of more than 20% versus almost no earnings growth) has created a significant difference between financial asset growth and real economy growth. We are still cautious that this enthusiasm towards a better growth environment is premature: the consumer demand is moderating and the industrial data is really only stabilising due to a weak base effect. However, if we assume that a better growth backdrop does occur in 2020, then the market's higher valuations show that a fair amount is already priced in for this recovery.

2019 saw an incredible move in equity markets with global market indices achieving returns in excess of 20%

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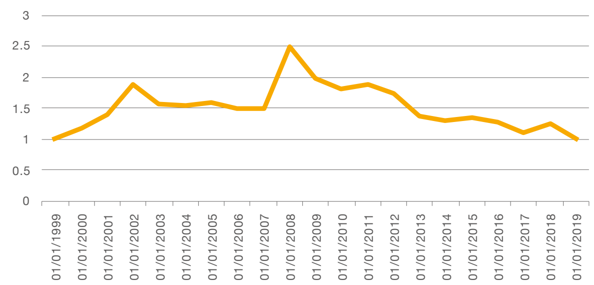
This situation could well create equity market problems in 2020, which is illustrated in the charts below:

US GDP v. S&P 500 (Base 31.12.1999)



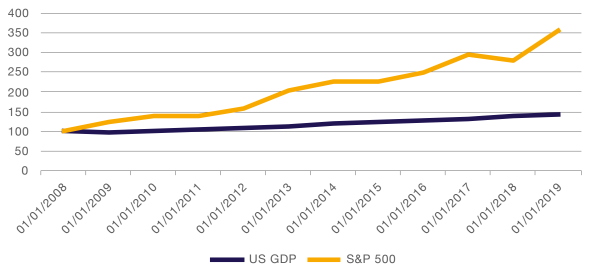
Source: Bloomberg, London & Capital

This chart shows the relationship between nominal US GDP and the US stock market (S&P 500) since 2000. The only time the stock market has been so highly valued against the US economy was during the 2000 Dot Com Boom, which is now widely regarded as the one of the most excessive periods for equity market valuation in history.

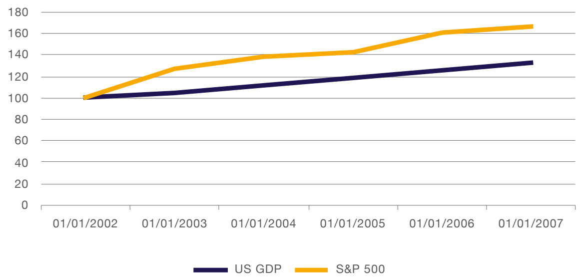
We are still cautious that this enthusiasm towards a better growth environment is premature: the consumer demand is moderating and the industrial data is really only stabilising due to a weak base effect

The two charts below illustrate the issue. After the global financial crisis, asset markets recovered much more than the real economy. This looks stretched for asset prices compared to other periods of recovery (for example for 2002-2007).

US Economy and S&P 500 2008-2019



US Economy and S&P 500 2002-2007



Sources: Bloomberg, London & Capital

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Many other warning signs are flashing caution and sentiment has become more exuberant. This might mean stock markets continue to run higher in the short term. However, chasing more economically sensitive stocks now looks late and dangerous. There is a risk of disappointment, especially given the risk of central banks becoming less able to support asset prices.

The London & Capital STAR strategies have performed well, participating with the market, despite a defensive bias. This was aided by stock selection and bond yield compression, helping income stocks, which are an important part of the STAR selection criteria.

Chasing more economically sensitive stocks now looks late and dangerous

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EQUITIES

OUR POSITIONING

We see an asymmetric risk/reward payoff, given valuations and expectations. If all goes well for the global economy and there is an acceleration in growth, then the market will likely produce mid-single digit returns. However, consumption and labour markets are slowing – and could be worsened by companies looking to cut costs given the anaemic economic environment. If the consumer weakens, it is difficult to see positive returns and a correction would be likely.

This dynamic can be shown by the following factors in the chart, opposite, (price-earnings ratio, returns and earnings growth).

The relationship between market returns compared to valuation (displayed in the P/E ratio line) and earnings growth is driven by expectations. The problem for 2020 is that earnings expectations may well be optimistic, and valuations do not support this.

While the market could continue to run in the short term, it faces the risk of central banks now becoming less effective. Adding to this, the Phase 1 US/ China trade deal conclusion is unlikely to stimulate growth.

Therefore, our Core Equity focus continues to be on high-quality defensive equities which will participate if markets continue to move higher but will show more resilience if markets correct.

Given our capital preservation philosophy, we will aim to preserve gains, rather than get dragged into "greedy" sectors which normally end badly and suddenly. Our view would change if markets saw a healthy correction and risk dissipated while the low and flat economic conditions remain unchanged.

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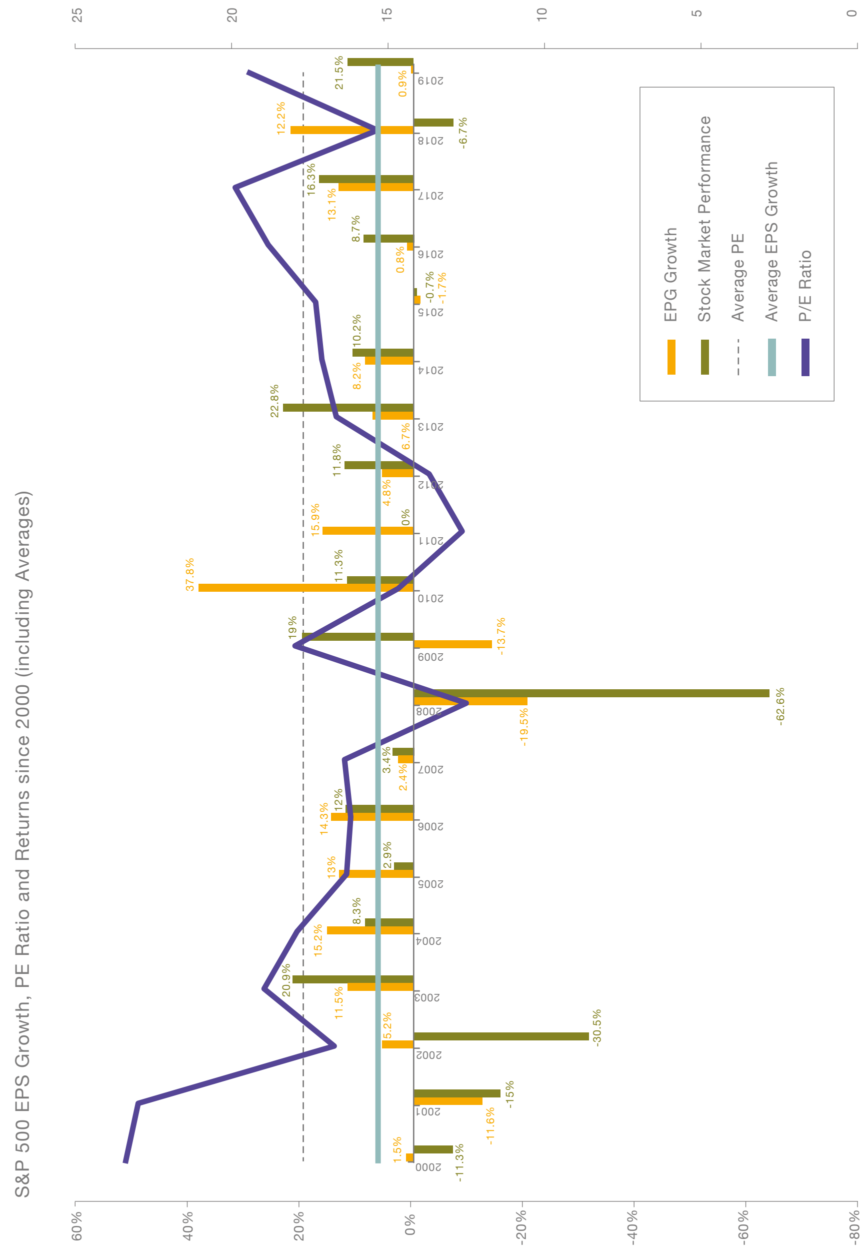

Source: Bloomberg, London & Capital

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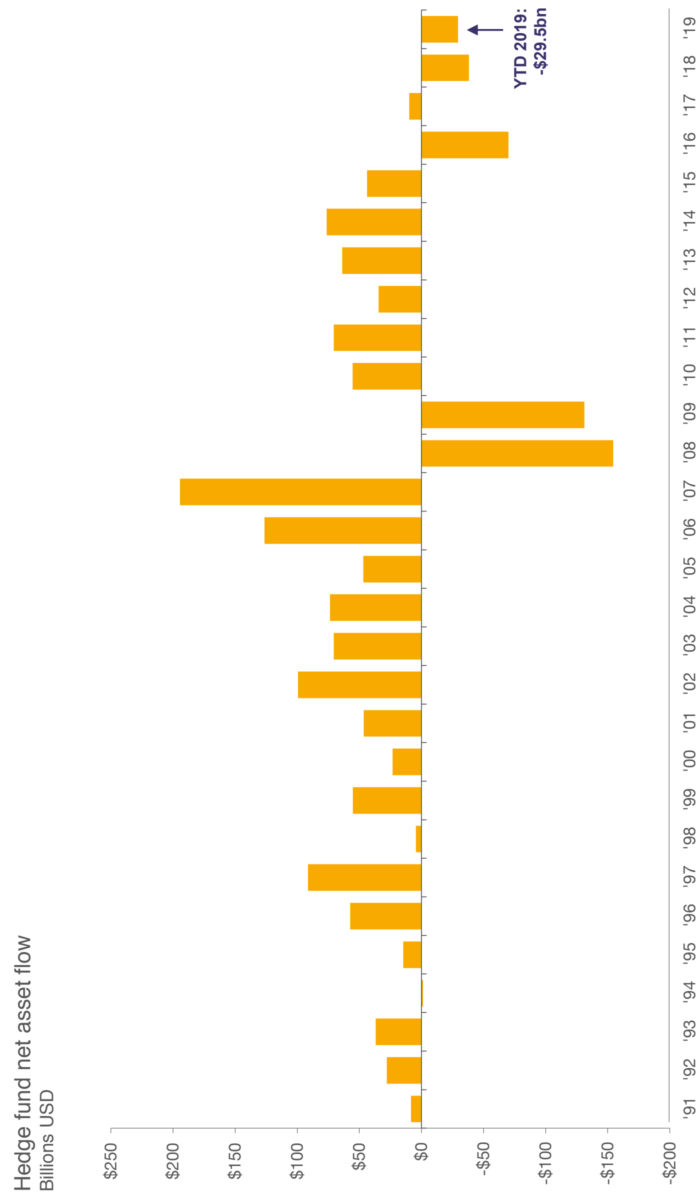
ALTERNATIVES
OVERVIEW

The hedge fund industry has continued its upward march in line with traditional assets, as managers - especially those running equity long-short strategies - have increasingly been sucked into the rally. From the lows of December 2018, net exposure to equities has increased to more than 70% with leverage touching 250%, according to Goldman Sachs. We have not seen this level since the beginning of February 2018, which presaged a large technical selloff and blow-up in short volatility strategies.

While we would not want to predict a similar outcome anytime soon, those aiming for true diversification should avoid the temptation to buy into long-biased strategies with recent buoyant returns. As the global economic outlook is still unclear, we prefer a more measured approach with managers that offer truly uncorrelated returns.

One of the more interesting recent market developments is a boom in corporate deal-making, with M&A volumes increasing substantially in Q4 2019. Going into 2020, we believe this creates a rich and potentially fruitful opportunity set for merger arbitrage strategies as deals traverse their regulatory path to completion. Those managers with the ability to navigate and take advantage of the volatility of deal spreads have the potential to make strong returns in the first six months of the year.

Industry flows have remained negative (according to data from HFR) as the big wave of institutional investment over the last 10 years has plateaued. Some high-profile funds continue to wind down and return capital (Moore Capital being the latest). Nevertheless, owing to positive performance, the industry has grown overall.



Sources: HFRI, J.P. Morgan Asset Management.
Data is based on availability as of November 30, 2019.

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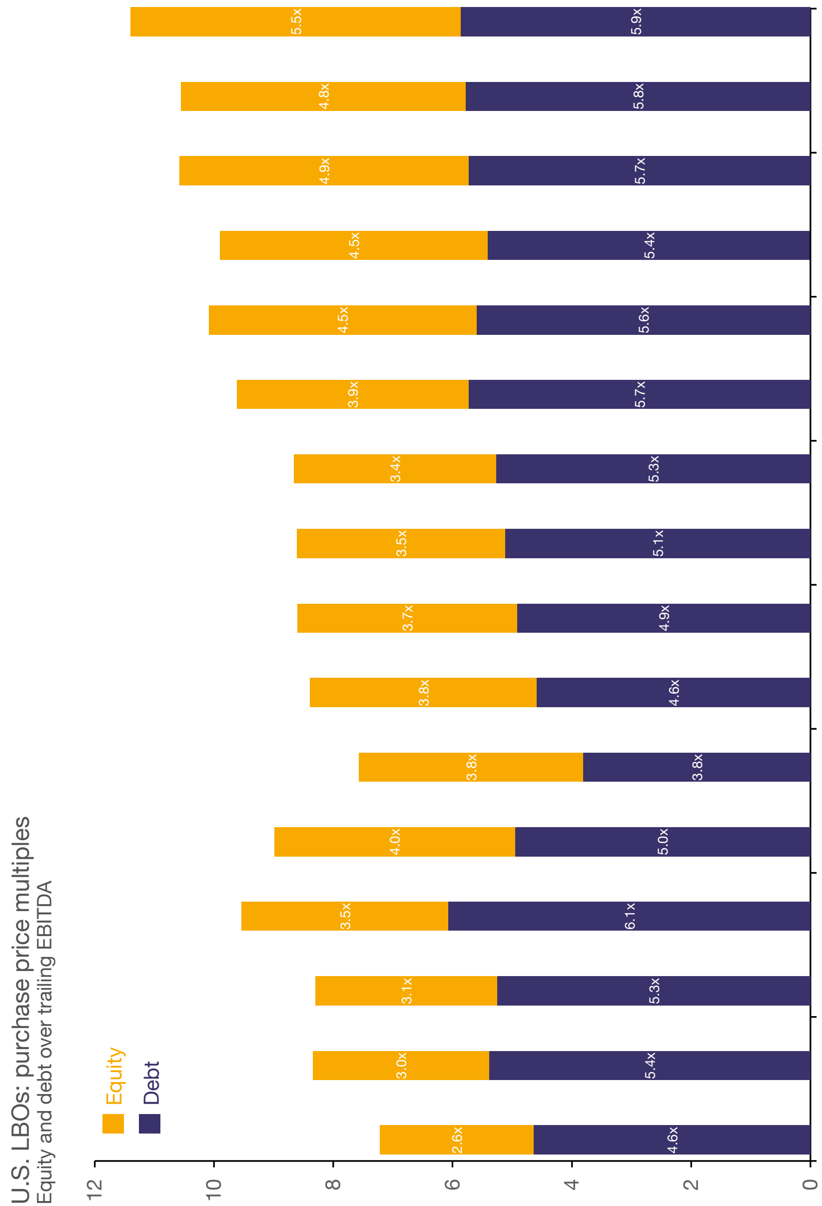
In terms of private assets - and even though the final data isn't available yet - it appears as though fundraising has been slightly subdued compared to the record years of 2017 and 2018. We believe this is in part due to the elevated levels of private equity valuations and debt multiples in private credit. For the same reason, as it has become harder to put money to work, there is now a lot of dry powder (capital committed but not drawn) on the side-lines, waiting to be deployed.



Source: Pitchbook, S&P LCD, J.P. Morgan Asset Management.
Data is based on availability as of November 30, 2019.

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ALTERNATIVES
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. In addition, we like liquid alternative income-generating strategies. The aim is to provide diversifying sources of return, capturing attractive alphas away from traditional long-only strategies.

London & Capital selects 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 adapt to the prevailing market environment. We are confident that we can deliver meaningful value for clients amid 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 in a decent return during the two most volatile months of 2019 (May & August), although the recent rotation to more cyclical 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 using a combination of debt, rates and FX.
- Event-driven strategies: arbitrage strategies across both hard and soft catalyst event-driven plays are enjoying a rich opportunity set and some complex situations which provide for added alpha, as well as volatility, providing good trading opportunities.

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.

- Lending/Leasing: we prefer asset-backed strategies across short-duration private debt (SME & real estate loans), and leasing strategies in global transport and business essential equipment.
- Renewables: we favour both established strategies in renewable energy generation (solar & wind) as well as emerging technologies such as battery energy storage.
- Royalty/Intellectual Property-based strategies: we have exposure to a relatively new song royalty fund which has strong secular growth dynamics due to the increasing prevalence of music streaming, as well as to a lending strategy, backed by high quality pharma patents and royalty streams.

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.

> **The aim is to provide diversifying sources of return, capturing attractive alphas away from traditional long-only strategies**

We prefer this over classic leveraged buyout or late-stage growth strategies, where valuations are stretched, and exits are becoming more difficult to achieve. As we move into 2020, the focus will be on delivering strong tax-efficient ideas for clients through a selection of Enterprise Investment Schemes. In addition, we look forward to implementing our Venture Ecosystem, allowing clients to share ideas, access capital and collaborate on direct private equity positions.

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FX

After reaching a high for the year at the end of September, the US Dollar came under pressure in Q4 versus all major currencies except for the Japanese Yen. Since the start of the year a narrowing of the growth and rate advantage enjoyed by the US relative to most other developed markets suggested the conditions for US Dollar downside were building, but it was the Federal Reserve's intervention to help calm a spike in repo rates (short-term collateralised loans between financial institutions) that ultimately proved to be the catalyst of weakness. The Federal Reserve announced at its December meeting it would maintain liquidity injections into January 2020, therefore expanding its balance sheet at the fastest pace since the financial crisis and most likely extending the US Dollar index's trend lower into the New Year. Given the Dollar's resilience prior to the Fed's recent actions and its indication that rates will be on hold throughout this year, we should be circumspect about persistent weakness if the Fed abruptly ends its repo market support and again starts to reduce the size of its balance sheet.

The outlook for Sterling next year looks more constructive regardless of the wider US Dollar trend

The outlook for Sterling next year looks more constructive regardless of the wider US Dollar trend. A renegotiated deal reduced the risk of a hard Brexit and triggered strong gains for the Pound in October versus both the US Dollar and Euro, a move that was accelerated by significant short market positioning. The general election announcement stalled gains during November, but polls indicating the likelihood of a GBP-friendly Conservative majority initiated another phase of strength. However, post-election gains were quickly given back following news Boris Johnson would use his new majority in Parliament to enshrine into law a hard stop to the Brexit transition, thereby re-introducing a new Brexit trade cliff edge at the end of 2020. Despite this fresh uncertainty, the election result has left the backdrop for Sterling looking more positive over the medium term. The political risk premium attached to the Pound is now somewhat lower and a confirmed EU exit should help to improve economic conditions by unlocking investment spending and repairing sentiment.

International investors who have ducked the UK in recent years may now start to be attracted back. The pound remains undervalued versus the US Dollar and recent developments could provide the catalyst to unlocking this value. If, as we expect, the US Dollar continues to trade on a weaker footing, this should translate into GBP/USD moving higher in 2020.

Similarly, the recent run of Sterling strength against the Euro should extend into 2020. Any economic improvement in Europe next year will only be modest and the European Central Bank is likely to maintain its policy setting of QE and negative rates throughout the year.

About London & Capital

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

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

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