Macro summary

The third quarter of 2018 has seen an escalating trade dispute between the US and China, a lack of progress on Brexit talks and higher interest rates from the Federal Reserve (Fed) and Bank of England (BoE). Despite these headwinds, the global equity market put in a positive return, with the US and Japanese markets especially strong. The third quarter was particularly positive for US companies' earnings and sales. It appears corporate earnings have been given a significant boost by tax reforms.

President Trump has been increasing tariffs on goods imported from China and the Chinese have retaliated. China's refusal to negotiate under these pressures could result in the dispute being protracted. Conversely, Mexico agreed a new free trade agreement and at the end of the month, Canada joined in with a new US Mexico and Canada Agreement (USMCA). President Trump heralded it as a major step forward. It does add protection for automakers and the US dairy industry but in other respects, it is an updated version of the North American Free Trade Agreement (NAFTA). We expect that in the end, the US and China will come together and sort out a trade deal. However, in the short term we are likely to see prolonged rhetoric on both sides.

Brexit negotiations have continued with very little progress on the substantive issues. The pound rose with the prospect of a deal sparked by Michel Barnier's comments that the UK could have an unprecedented deal with the European Union. The FTSE 100 has a high proportion of overseas earnings, therefore it weighed down the UK market. Still, as it became clear at the Salzburg meeting, there was no real progress on the key issues, principally in relation to the Irish border. The deadline for a deal appears to have slipped from October to November but as it nears, we expect more volatility, particularly for the pound.

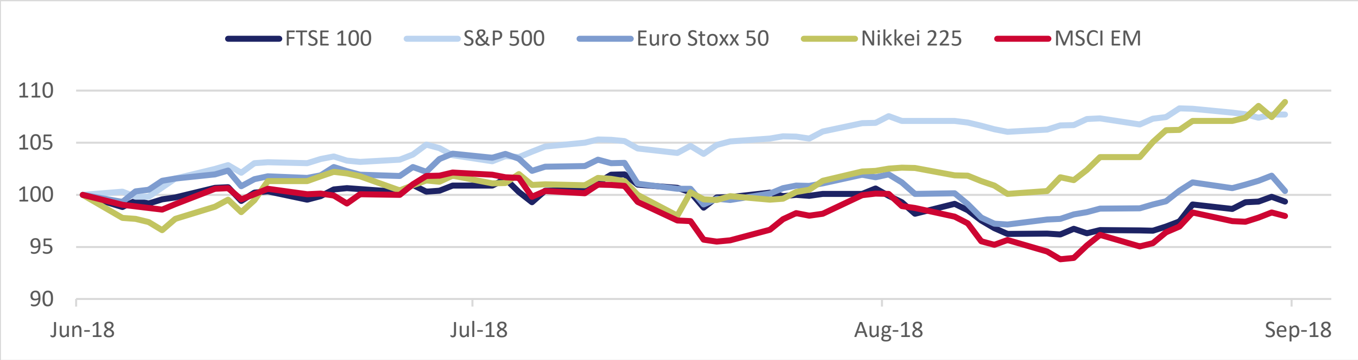
The Federal Reserve raised rates for the eighth time since 2015 and the BoE raised rates for a second time in this cycle. While the bond yields moved higher, the actual rate rises were so well flagged in advance that they had little impact on equity markets. The Fed is expected to raise rates again in December but the BoE is not expected to move again until the middle of next year.

On the back of this, global financial conditions have tightened somewhat resulting in headwinds for emerging markets. The European Central Bank (ECB) has indicated that it will end its asset purchases by the end of this year before raising rates in the second half of 2019. However, the recent rise in Italian bond yields as a result of the contentious budget negotiations have resulted in an undue tightening of financial conditions in Europe that could derail the ECB plan.

In Japan, Prime Minister Shinzo Abe saw off a challenge to his leadership. The continuation of so-called "Abenomics", combined with a weaker yen, supported the equity market. Other Asian and emerging equity markets have suffered this year from the effects of trade disputes and a strong US dollar.

Looking forward to Q4, we will continue to see political uncertainty with elections in the US and Brazil. Continuing trade disputes and negotiations around Brexit is likely to add volatility in the short term. Nonetheless, we believe that the UK market is attractive, particularly relative to gilt yields. US company earnings and sales growth continue to support our positive outlook for equities.

Figure 1: Equity indices (local currency/total return)



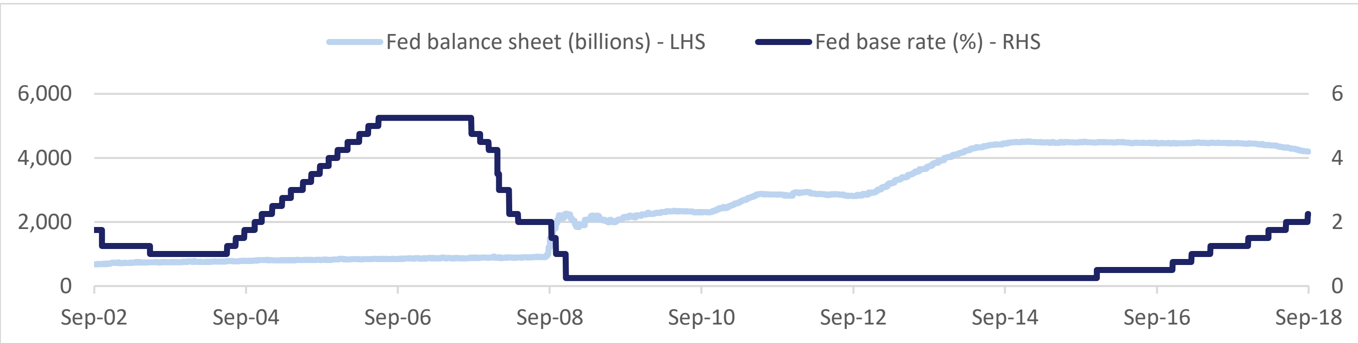
Source: London Stock Exchange/Standard & Poor's/ Stoxx/Tokyo Stock Exchange

Fixed Income

When we consider the importance of central banks across the world, there is only one bank that tends to get described as the central bank of the world, the US Federal Reserve (Fed). There are several reasons why this long-held view remains true to a certain extent. Firstly, most commodities are quoted in US dollars, facilitating a need for open economies to hold a certain amount of dollar reserves. Secondly, the US debt markets are the largest and most liquid in the world which attracts borrowers ranging from emerging market (EM) countries to global corporations. These factors help to explain why movements in US monetary policy have ramifications across the world.

This year we have seen the differential in base rates between the US and its developed market peers which continue to widen. Growth in the US has remained on a firm footing with survey data hitting multi-decade highs and small business optimism achieving a new all-time high. The fiscal stimulus has clearly continued to boost US growth but this prosperity has not been shared globally as escalating trade wars have held other countries back. Based on these trends, the Fed felt comfortable to raise interest for a third time this year by a further 0.25% taking base rates to 2.25%. As things stand, they are on course to raise rates by a further 0.25% at their December meeting. On top of this tightening, the Fed is still implementing its Quantitative Tightening (QT) programme which entails fewer reinvestments of government and mortgage debt holdings resulting in a declining balance sheet. This two pronged tightening (figure 2), paired with significant dollar repatriation, has led to a shortage of dollar liquidity and has resulted in a tightening of global financial conditions.

Figure 2



Source: Federal Reserve

These conditions are extremely challenging for EM countries that operate with large US dollar debt. Turkey was particularly vulnerable given its twin deficits. This was not aided by the appointment of President Erdogan's son-in-law to oversee economic policy, which was perceived as interfering in central bank independence. The situation quickly escalated as the US imposed sanctions on Turkey as it refused to release a detained US pastor. Even though the Central Bank of Turkey raised its deposit rate by an above market expectation 6.25% to 24%, the Turkish Lira still closed around 25% lower versus the USD over the quarter. Argentina was another country that had to resort to drastic measures, raising their benchmark interest rate from 40% to 60% over the quarter to combat further currency devaluation as inflation is already spiralling out of control. While these two represent the more extreme market movements, no EM countries were immune to the tightening liquidity conditions, with significant falls in the broader EM FX complex.

Although the gap between the US and other country base rates widened, there were some central banks that also took steps to tighten monetary policy. Canada has raised its base rate twice this year, taking interest rates to 1.5% and it is expected to raise it once more at its October meeting. The BoE hiked rates in August by 0.25% to 0.75%, the highest since 2009. While the mixed data in the first half of the year held the central bank back, the more sanguine outlook paired with a tight labour market gave the BoE the confidence to raise rates this quarter. As they increased interest rates, they reiterated a slow and steady approach with no further increases expected ahead of much desired Brexit clarity. The Governor of the BoE, Mark Carney, has extended his term to promote stability during the heated final negotiations. The ECB reiterated its stance with the asset purchase program reducing to €15bn a month in October before concluding at the end of the year. This plan has been complicated by the erratic nature of the current Italian government; the ongoing budget negotiations between the government and the EU are contentious. Considering the already high debt levels in Italy, a big budget hole is raising further sustainability questions and has put further pressure on Italian sovereign bonds. At a time when the ECB is eyeing to exit its extraordinary monetary policy stance, an Italian political/debt crisis is likely to represent a large impediment.

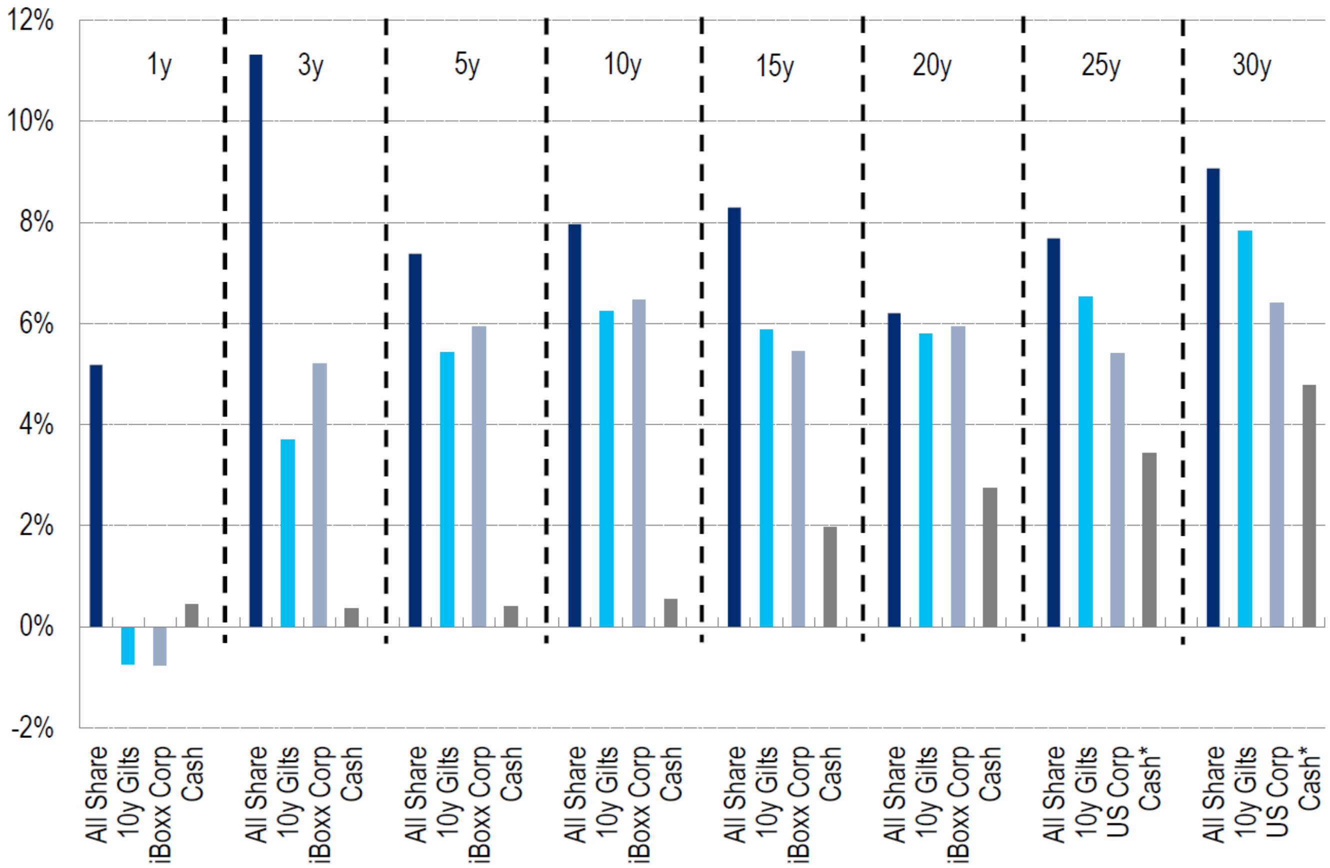
Credit spreads were on a firmer footing over the quarter after the widening that took place previously. Most global equity markets delivered positive returns which in turn supports the risk sentiment in most developed markets. The more modest supply calendar has also improved the technical picture providing further support. Spread returns have been solid over the quarter with the lower quality credit outperforming as volatility declined and default rates remained very low.

Equities

UK Equities

The key to domestic equity returns over the longer term has been earnings growth, and thanks to this support, UK equities still appear to be attractively valued.

Figure 3: Annualised total returns



Source: Citi Research
FTSE All Share Index, 10y UK Gilts, iBoxx Corporate Bond Index, Cash

There is no hiding from the fact, however, that the first three quarters of 2018 are now behind us and the UK equity market has continued to struggle to move into positive territory. Trade war concerns have not helped, as many of our leading companies are exposed to international growth, but market sentiment has also suffered from concerns that infighting within the Tory party could result in the UK and the EU being unable to agree a free trade agreement – a possible outcome that is commonly referred to as a 'hard' Brexit.

Opinions vary about the effect that this would have on the economy, but in our last quarterly missive we used the example of Honda's car plant in Swindon to illustrate just how tariffs and customs checks could lead to widespread, and costly, supply chain disruption. Honda's storage requirements to continue a seamless production line go beyond the additional building costs alone. The Financial Times said in its report on the subject, the "cost to operate (such a centre) would be as eye-catching as its proportions".

One may be tempted to dismiss these concerns on the basis that Honda is an isolated example, but BMW rammed home the point recently by declaring that they would actually move production of the Mini from its current plant at Cowley, just outside of Oxford, to the Netherlands if there was a hard Brexit. The CEO of Next also hit the headlines recently with a forensic, and fairly chilling, document that detailed the 'administrative, legal and physical infrastructure' requirements in the event of a 'hard' Brexit. Queues and delays at UK and EU ports as a result of increased customs declarations for other companies was deemed a 'high risk' event.

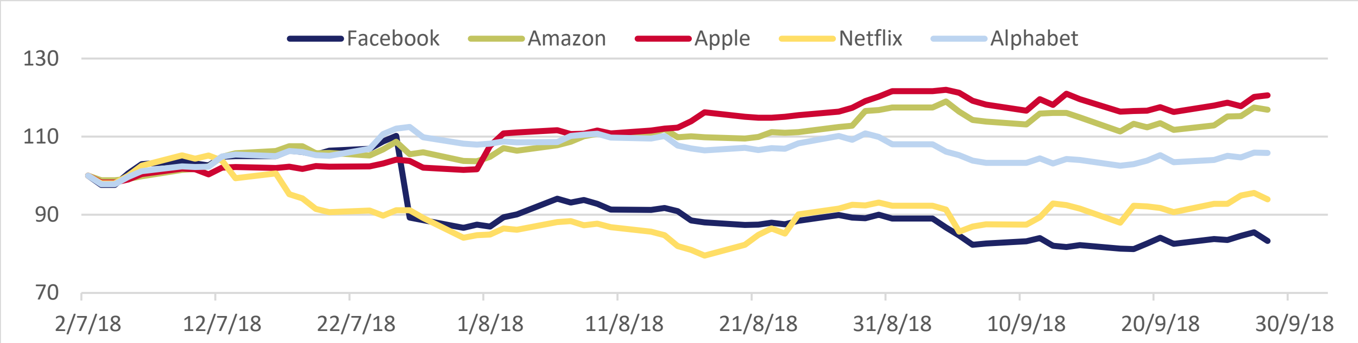
The clock is ticking, and we have no clear sense of whether the whole issue will result in a deal, a second referendum, or a general election following a no confidence vote in Mrs May. What seems clear is that a so called 'soft' Brexit, which prioritises continued market access, is likely to result in the pound rebounding, whilst crashing out is likely to see the pound fall. The currency move has an impact on the market as a whole, however individual stocks may react very differently. Companies with a domestic focus may benefit as investors return to the UK post a 'soft' Brexit as the resulting clarity should spur increased domestic investment. However, international companies with a high proportion of overseas earnings may benefit if the pound falls if a trade agreement cannot be agreed. Bigger companies tend to be more international but this is broadly a company issue and not solely a factor of size and/or sector. Within the banking sector, HSBC has most of its operations overseas and hence it should outperform if the pound falls whereas Lloyds, which has largely domestic operation, may do better in the event of a 'soft' Brexit. In any event, we expect a greater dispersion of returns as Brexit nears.

With such uncertainty, we continue to try and pick a sensible path through the minefield and place emphasis on individual stocks that encompass robust balance sheets with surplus free cash flow, good future prospects and are operationally sound. Many of these stocks offer attractive dividend yields, and we continue to believe that income will be an important component in the overall returns that are delivered from this point on. We recognise the possibility of bid interest in UK stocks with depressed valuations, and are also alert to various political and economic developments.

International Equities

The MSCI World had its strongest quarter of the year in rising 5% in dollar terms (6% in sterling). This was driven once more by the US market where the broad S&P 500 index rose 7% and the technology-heavy Nasdaq rose 8%. The largest companies in the world made some eye-watering moves in the quarter with Apple rising 20% adding $190bn of market capitalisation to become the world's first trillion dollar company. A few weeks later Amazon (briefly) joined the trillion dollar club as it rose 19% and added $150bn to its market capitalisation during the quarter. Alphabet, the parent company of search behemoth Google, rose 7%. Microsoft continued to show robust sales growth as its customers moved from one-off licenses to subscriptions operating clients' servers in the internet cloud leading the stock to rise 16%. In stark contrast slowing user growth for both Netflix and Facebook saw the stocks fall over the quarter.

Figure 4: Diverging performance of FAANG stocks



Source: Bloomberg

The robust US economy and further interest rate rises (both actual and expected) saw solid earnings growth from the banks sector and accordingly the US's largest bank JP Morgan rose 7%. This, and rising wages (which will benefit the company's customer base) saw supermarket chain Walmart join the online stocks in rising 9% in Q3 2018. Warren Buffet's Berkshire Hathaway, a US economic bellwether with its vast insurance and industrial operating businesses as well as stock holdings, rose 14%.

Indeed the four largest companies in the world – Apple, Microsoft, Amazon and Berkshire Hathaway added a combined $447 billion in market capitalisation during the quarter, which is almost 20% of the market capitalisation of all the companies in the UK's FTSE 100 index.

The MSCI Europe ex-UK rose 3% in sterling terms. Once more European financials struggled for positive momentum - after falling 6% and 5% in Q1 and Q2 2018 they eked out a 1% gain in Q3 2018 with European banks falling another 3% during the quarter as concerns over weak capital bases remain.

In Japan the broad-based Topix index rose 5% in local currency driven by the bank sector as Prime Minister Abe-San survived a leadership challenge to keep his reforms to the Japanese economy on track.

While President Trump continued his game of 'one potato, two potato, three potato, four' in ratcheting up tariffs on Chinese trade, the Shanghai index lost another 2% during the quarter as investors' hopes for a rational conclusion once more faded. At the same time, the Chinese government played up its moral arbiter status in refusing to approve various new mobile games and restricting access to others in order to address the 'addiction' of young children. Hence, social media mega cap Tencent fell 18%, online shopper Alibaba 11% and search engine Baidu 6%.

Brazil recovered half its 15% fall during Q2 despite the latest election seeing the leading (right wing) candidate stabbed at a campaign rally and more corruption charges looming for other (left wing) candidates. But EM as a whole fell 2%, hampered by the stronger dollar.

Alternative Investments

Hedge Funds/Targeted Absolute Return

Absolute Return funds, as measured by the Absolute Hedge Global Index, were slightly down for the quarter. Multi-asset strategies were the strongest style over the quarter. However, over the year the equity/long short has performed better, remaining our preferred strategy alongside event driven. Following a difficult period, with deals broken by political interference, event driven has enjoyed a better backdrop this quarter. The fiscal reforms resulted in a bumpy year for mergers. Fuelled by the fiscal reforms in the US at the end of 2017. Stock dispersion continued to create opportunities for equity long/short strategies. However, Asian focused funds that had a net long position suffered. The higher volatility in rates and foreign exchange benefited some global macro managers over the quarter.

Looking ahead, absolute return strategies should be able to exploit and capture the increased volatility and dispersion seen across asset classes. We continue to believe that good managers can perform a valuable diversifying role in portfolios, particularly in an environment of rising bond yields and tightening liquidity. These strategies have the tools to reduce market downside risk. We continue to favour a diversified approach within the alternative allocation in order to maximise the array of sources of return. Event driven should continue to benefit from increased corporate actions, however risk remains due to the political climate. Stock dispersion remains high and this should help long/short managers identify winners and losers. Trend following strategies offer diversification of return given as they have the potential to capture returns that are not directionally dependent. As ever, manager's selection remains key to success in these funds.

Property/Infrastructure

Property returns over the quarter remained challenged by a combination of rising financing costs and the commercial uncertainty stemming from Brexit. As bond yields start to rise, the valuation cushion between the yields available on property and more liquid fixed income investments comes under pressure. At the same time, structural change (such as e-commerce) is disrupting the relative attractiveness of different types of property. In the UK, retailers have fallen afoul of a switch of high street shopping to online. The rescue package agreed for House of Fraser involved substantial renegotiation of rental agreements and store closures in some cases. A similar trend can be seen in the restaurant business with a record number of food outlets closing.

Aggregate house price growth in the UK remained stable during the quarter, although high regional dispersion saw some areas of the market (for example expensive London boroughs) fall. More affordable parts of the country continue to grow at a modest pace.

Global Real Estate Investment Trusts (REITs) were down for the quarter, with high regional variation. In the US, REITs fell as bond yields rose, whilst in Asia, REITs performed better than the wider markets as investors sought the perceived safety of steady income streams and tangible assets.

Infrastructure has seen both event risk and political risk manifest itself this year. Italian toll road operator Atlantia, fell 33% following the Morandi bridge disaster. Here in the UK, the threat of nationalization ebbs and flows with the popularity of the opposition. Debate as to how to fund necessary investment moving forward is likely to be a central feature of the polarised political landscape for some time, creating an environment of volatile sentiment in this asset class.

Looking ahead, rising bond yields will likely continue to create headwinds for property, whilst changing trends make sector and regional selection as important as ever. Affordability concerns in the residential housing space is countered by the lack of supply, even though house prices have risen faster than wages for many years. Political initiatives, such as those aimed at reducing foreign demand, might continue to challenge the luxury end.

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