RICHMOND HOUSE
INVESTMENT MANAGEMENT

RHG Investment Commentary – Q4 2017

Very much like the previous quarter, the Federal Reserve raised interest rates by 0.25%, from 1.25% to 1.5% in December, but, again, the US dollar continued to weaken over the quarter which made financial conditions easier. This supported risk assets and all asset classes generated positive returns over the quarter. These conditions were most beneficial for emerging markets, which are sensitive to the strength of the US dollar, while investors were also surprised by the strength of China's growth after the Party Plenum in October. Positive returns were generated from the RHG Models over the quarter to 31st December 2017, ranging from 1.1% (RHG Strategic) to 3.3% (RHG Enterprise).

In the USA, after much effort, President Trump was able to get the tax cut and reform bill through Congress and passed into law. This helped US equities to rise but on fears of higher deficits did not support the dollar. Trump was also able to postpone the debt ceiling negotiations to January 2018. In terms of foreign policy, Trump continued to threaten North Korea over its ballistic missile launches and he antagonised the rest of the world by moving the US embassy in Tel Aviv to Jerusalem and slashing the US's contributions to the UN. This prompted countries to move away from the US dollar while Venezuela said that it would not use the dollar at all. While US markets rose to record highs on the back of higher overseas earnings, profit warnings from global bell-weather companies like General Electric remind us that at a stock level there have been some disappointments this year and bad news has been punished quite severely. Even the most-favoured 'FANG' stocks of Facebook, Apple, Netflix and Google faltered in the quarter as questions began to be asked of their growth rates and political involvement.

In China, the Communist Party plenum finished with President Xi being nominated the most powerful 'core' leader since Mao Zedong and Deng Xiaoping. Xi laid out his ambitions to strengthen national security and for China to become a global power. Xi will introduce policies to increase the country's prosperity while reining in some of the problems caused by China's rapid, credit-fuelled growth. In Japan, Prime Minister Abe called a snap election in October, which he duly won with a super-majority. This encouraged investors to anticipate even more monetary and fiscal stimulus policies and the Japanese stockmarket rose over 10% in the quarter in local currency terms. The yen, however, barely moved as the Bank of Japan has been discretely tapering its quantitative easing as it has needed to buy fewer bonds to keep the 10-year government bond yield at 0%.

In the UK, Brexit has continued to dominate the headlines. In December, the UK and EU agreed on phase one of the divorce proceedings which lets the phase two negotiations start in March 2018. The UK consumer is beginning to struggle, though, as retail sales and the housing market show signs of weakness. It was therefore slightly strange to see the Bank of England raise the base rate from 0.25% to 0.5%, although all this did was reverse the equally-surprising cut on the back of Brexit. Nationalist politics resurfaced elsewhere in Europe over the quarter which initiated another bout of weakness in Eurozone markets. In Spain, the Catalans voted twice for secession from Spain. In Italy, the president dismissed parliament and called an election in March 2018 and Poland is fighting the EU over judicial reforms.

The other topic of note this quarter was the meteoric rise of Bitcoin which rose from just over $4k at the beginning of October to over $19k in December before falling back to $14k when Bitcoin-related activities were banned in several countries and Bitcoin futures, which allowed investors to short the cryptocurrency, were launched. This is an area that remains hugely speculative, and hugely volatile, which is not a desirable feature of a currency. However, long-term consequences could be dramatic if it were to become more mainstream. We watch with interest how governments respond to the developments.

Stockmarkets, globally, were up in the quarter, with Japan outperforming other developed markets, gaining 11% (Nikkei 225 index) in sterling terms. Commodity sectors were the best-performing sectors and defensive sectors, like healthcare and utilities, were the weakest. Equities continue to look fully-valued on historic metrics except in comparison with fixed income where yields remain at historically low levels so we remain underweight. Bond yields picked up in the quarter. Credit risk sold off so developed market government debt outperformed corporate debt and emerging market debt. We remain underweight interest rate risk as central banks start to raise rates and underweight credit risk due to expensive valuations.

The WTI crude oil price rose from $51 to $61 as OPEC maintained its production cuts and the proxy wars between Iran and Saudi Arabia escalated. Metals, broadly, rose over the quarter as China closed its inefficient producers and the lack of capital expenditure globally over the last two year put pressure on supply. In addition, investors have been bidding up the prices of lithium, cobalt and nickel that are key materials for electric vehicle batteries.

Market summary over the last quarter

- The US dollar continued to weaken despite a further interest rate rise in December.
- Emerging markets performed strongly over the three months as China's growth continued, commodity prices rose and the dollar weakened.
- The oil price rose over the quarter due to OPEC cuts and the increasing antagonism between Saudi Arabia and Iran.

Our shorter-term outlook

- A weakening US dollar should support global growth and US and emerging market equities.
- Tightening credit markets will slow growth in leveraged economies.
- Central banks are increasingly tightening monetary policies and higher bond yields would likely cause an increase in volatility.
- The UK equity market remains very sensitive to both Brexit and sterling.
- Watch out for the launch of China's oil futures contracts on 18 January.