RHIM Investment Commentary – Q1 2018

After falling consistently throughout 2017, the US dollar was largely stable in Q1 2018. As the world's reserve currency stopped weakening, the talk of synchronised global growth at the end of 2017 dissipated as financing conditions stopped getting easier and risk assets experienced a correction and a pick-up in volatility. The RHIM Models, which were defensively positioned, were down a couple of percent over the quarter to 31st March 2018 but they generally fell over a percent less than their sector peer groups. For instance, the RHIM Blended model, was down 2.4% compared to the -4.1% fall for the IA Mixed Assets 40-85% Shares sector and a 7.2% fall in the FTSE 100. Over 12 months to 31st March 2018, the total return for the FTSE 100 was a mere 0.2%.

Markets started off the year on a tear, rising rapidly and consistently as volatility in asset markets, as measured by the VIX index, i.e. how much assets move up and down, fell to record lows. A lot of investors had noticed the trend and were increasing their income yield by selling volatility. At the same time, the cost of borrowing as measured by the 10-year US Treasury yield had been climbing fast from 2.4% at the start of the year to just shy of 3% in early February. Arguably, volatility should never have got so low. At the end of January, volatility returned with a vengeance and equity markets fell sharply. The fall stopped when several 'short-volatility' products that investors had been using were wiped out and closed. In this 'risk-off' environment, it was interesting to note that traditional safe havens did not work. The US dollar with its yield advantage over other developed nations should have strengthened but didn't. The Japanese yen should have risen as Japanese investors repatriated their money from overseas markets but it barely moved. Bond prices should have risen but the 10-year US Treasury yield remained stable around 2.9% rather than falling towards, say, 2.5%, as might have been expected. (Bond prices rise as their yields fall.)

In the USA, Jerome Powell took over from Janet Yellen as Chairman of the Federal Reserve but there was no change in approach. The Federal Reserve continued to shrink its balance sheet and it raised the Federal Funds Rate by 0.25% in March to 1.75% as well as guiding markets to expect a further three rate rises in 2018. This tighter monetary policy was echoed in comments from the UK and European central banks that they would look to raise their interest rates and reduce their monetary easing policies. However, Japanese investors have been selling their US government debt as the cost of hedging out their currency risk is too expensive while the Chinese government has said that it will not increase its Foreign Exchange reserves which are mainly made up of US government debt. In addition, President Trump has been forcing other nations like Russia and Iran off the US dollar by imposing sanctions on them and threatening them with trade wars. As a result, there are fewer parties willing to finance the US government when the US gross national debt grew by $1 trillion in just six months to February 2018. A greater issuance of debt should result in a weaker US dollar.

Equity markets recovered some of their losses in the second half of February before falling back again in March. This was partly due to a correction in the technology sector as Facebook was accused of selling customer information, President Trump started tweeting against Amazon, Moody's downgraded Tesla while question marks remain over the rate of Apple's growth. The technology sector has been one of the main drivers of equity markets over the last few years so this was an interesting change in market leadership.

Elsewhere, China has been addressing its runaway financial sector with a handful of public arrests and bail-outs. Reducing the provision of credit to the economy will likely lower the country's growth rate. Consumption is rising and becoming a more important driver of the economy than manufacturing. In Japan, the governor of the Bank of Japan was re-elected, together with two advocates of expansionary policy, to continue his reflationary strategy. In Europe, a transitional Brexit deal was agreed between the UK and Europe which saw the pound strengthen. The Italian election was won by anti-European parties but they have not yet been able to build a coalition. Cryptocurrencies had a poor quarter as authorities around the world talked of outlawing them – Bitcoin fell from $14.8k to $7.0k. It has, however, been making a bit of a comeback over the last two weeks in April.

Global stock markets generally, were down in the quarter, with Japan and emerging markets outperforming Europe, UK and the USA. The Topix index was down 2.2% in sterling terms while the S&P 500 was down 4.4%. Commodities have been the best-performing asset class this year as the crude oil price remained high at $74, Trump's sanctions on Russian businesses caused a shortage of certain metals and the US-China trade wars targeted Chinese metal industries and various US foodstuffs. The traditionally defensive healthcare sector was the best sector while technology was the weakest as discussed above. 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. Government bond yields declined slightly over the quarter while credit spreads widened considerably 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.

Market summary over the last quarter

- Equities fell on higher volatility and higher bond yields.
- Traditional safe havens offered little protection from falling assets.
- Commodities rose on the back of US sanctions and increasing talk of trade wars.
- Revelations about Facebook highlighted how governments are on the back foot in regulating these businesses.

Our shorter-term outlook

- A weakening US dollar should support global growth and US and emerging market equities.
- Central banks are increasingly tightening monetary policies and higher bond yields would likely cause an increase in volatility.
- Higher commodity prices, if maintained will cause a pick-up in inflation, and could force central banks to tighten quicker than they would like.