RICHMOND HOUSE
INVESTMENT MANAGEMENT

RHIM Investment Commentary – Q2 2018

The second quarter of 2018 saw increasing tension in the market, if not volatility. The US Federal Reserve talked of speeding up its rate rises while it also increased the rate at which it takes money out of the market. This caused the US dollar and US Treasury yields to rise. As the global reserve currency became more expensive and the world's cost of borrowing went up, countries that rely on external funding were squeezed, threatening the outlook for global growth. In addition, the price of oil went up in dollar terms; a further headwind for growth. Of equal concern was the weakening economy and currency in China as the authorities tackle its historic lending excesses and President Trump ramped up his trade war rhetoric with China and Europe. With weaker global growth, higher borrowing costs and more expensive energy, the quarter was a veritable storm for emerging markets. To compound their problems, foreign investors sold their emerging market investments.

As a consequence, investment returns were quite binary: US investments did well as share buybacks and last year's tax reform pushed up earnings per share while emerging market investments did poorly. Increasingly, though, these problems are beginning to trickle back into the US itself.

The FTSE 100 was up 9.6% in the quarter, in part due to strength of the oil price, whilst the S&P 500 was up 9.7%, mainly as a result of technology stocks involving a narrow range of companies, known by the acronym FANGs or FAANGs (Facebook, Apple, Amazon, Netflix & Google). However, emerging markets underperformed developed markets and their currencies fell. The MSCI Emerging Markets index was down 3.5%. Japanese growth stocks performed well, although the Topix index was only up 3.1% in sterling terms.

The quarter started with rising oil prices and markets and funds that had exposure to these markets performed strongly. The FTSE Oil & Gas sector was up 20% over the quarter, however financials were one of the weaker sectors, up only 3.5%; an increasingly flat yield curve is not conducive to margins on loan books. US Treasury yields climbed through April and May to more than 3% in the case of the 10-year Treasury. However, the European Central Bank reaffirmed its ultra-easy monetary policy and Japan remained committed to keeping 10-year bonds 'at or close' to zero. Towards the end of the quarter increased concern around trade tariffs contributed to a worsening global picture and this benefited the perceived safety of the US dollar and US Treasury yields fell back below 3%.

The US dollar continued to climb through the quarter, particularly against sterling and the euro as the anti-establishment coalition took power in Italy. What felt like the only good bit of news in May came when Russian and Saudi Arabia agreed to relaxing oil production limits at the end of the month which caused the oil price to fall below $70 a barrel in the case of West Texas Intermediate (WTI). Unfortunately, it then spiked higher again in June as President Trump renewed his call for sanctions on Iran. Trump also went on the attack against China and Europe in his attempts to reduce the US' current account deficit. As the threatened tariffs mounted, so China allowed its currency to weaken to offset the cost of these tariffs as well as responding with tariffs of its own. China also tightened conditions in its deregulated financial industry which, together with lower imports, sparked fresh fears of a slowdown in the Chinese economy.

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The sterling dollar relationship reversed course in April. Sterling had been steadily climbing against the dollar over the first part of the year, but on the 17th April this went into the reverse, as the new Federal Reserve chair made it clear that US interest rates would continue to move higher whilst the UK's Brexit negotiations drew closer, putting pressure on the pound. The falling pound since April has contributed towards the US equity market being the best performing equity market for UK investors in Q2, as currency appreciation has boosted US equity returns.

Meanwhile, fixed income has remained out of favour. As we have flagged for some time, with the headwind of rising government bond yields since July 2016 and with credit spreads tight by historical standards there has been a limited return profile available from fixed income investment. However, with US yields 10-year yields now hovering around 3% we feel that in the short term at least the headwind of rising government bonds has now eased. However, outside of the US bond yields remain lower, held back by a combination of weaker growth prospects, QE programmes still in place (Japan and the eurozone) and generally benign inflation outlooks. The question is whether the US can continue charging ahead if growth elsewhere is significantly weaker.

The latest development regarding US tariffs has added further to risks in the short term. These tariffs, mainly but not exclusively aimed at China have resulted in some significant divergence in performance at a country and stock level. China's currency has been particularly weak and the higher cost of goods in the US will result in either higher prices (therefore inflation) which could crimp demand, or lower margins as companies struggle to pass these costs on (lower earnings). Either way, we struggle to see tariffs will not inflict some damage on US itself.

Market summary over the last quarter

- Trump's trade wars are intensifying.
- Developed market equities rose and emerging markets fell.
- The US dollar and US Treasuries were the safe havens even though the US fiscal deficit is increasing.
- The oil price rose on the back of US sanctions on Iran and OPEC production cuts.
- China allowed its currency to weaken, and corporate defaults rose.

Our shorter-term outlook

- We expect 2018 to remain challenging.
- A strong US dollar is not supportive to global growth or emerging markets.
- 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, which could force central banks to tighten quicker than they would like.

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