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B Capital Commentary and Outlook Update 2H2019

The end to 2018 was as rough for investors as the resurgence in equity markets has been surprising in the first half of 2019. Indeed after a December that saw the worst market performance since the Great Depression, there was some hope that it was overdone - as suggested in the year-end report - and with relief, it has proved to be so. Yet the question that follows and which may be on many investors' minds right now is whether this is a relief rally or one that has some further room to go.

Breaking down the macro picture we see the US with near full employment, low inflation and a robust group of consumers as a result. On the other hand, US business confidence has been waning for over 12 months, and the ISM Manufacturing PMI in the US fell to 51.7 in June 2019. It was over 60 a year ago. Of S&P500 companies that have changed their earnings guidance in the first half of the year, 80% have cut their earnings outlook. The data is therefore quite mixed and it is no easy task to determine what this could mean for investors. The ongoing lack of progress in the war on tariffs by President Trump continues to cause some uncertainty and is weighing on investor confidence, not to mention the likely caution CEO's must have when weighing up orders and investment plans. To keep everyone on their toes the President is also shouting at some regions for weakening their currency to offset the slowdown caused by the trade war. He then shouts at his own Fed Governor to lower interest rates, which would depress the dollar and so he is directly trying to play the same game that he accuses others of engaging in.

China is moving along pretty steadily for now. The bears cite a faked growth rate from the Politburo but the official facts are showing a steady picture despite the spat with the US Administration. The Chinese economy advanced 6.4% year-on-year in the first quarter of 2019, the same pace as in the previous quarter and slightly above market expectations of a 6.3% expansion. The renminbi has weakened a little and may well be allowed to weaken as far as RMB7 to the dollar, as the central bank uses monetary tools to offset any slowdown whether caused naturally (the growth is widely held to be weaker over the next decade) or caused by more US political wrangling and any ensuing tariffs. The rest of Asia will follow a derivative path as a result and cannot avoid the ripples caused by the two big fish as they play out the trade war duel.

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It has been a repeated concern that Europe is the laggard on the global stage. Infighting between countries and even fractions within countries in the EU means that the region has its eye off the ball whilst the other major players move forward and grow stronger. The UK decision to leave the Bloc on the western boundary has caused extensive damage to growth on both sides of the Channel, and in the south Italy fails to grow and plays a game of chicken with the EU over its budget. These are two big economies in Europe and too big to ignore as they make a mess of the numbers. The UK political muddle has crimped its growth to a mere 1.1% forecast for the second half of 2019 and its currency has now headed back down to the Brexit lows. The ECB at a meeting in Sintra, Portugal last month announced that it was ready to open the taps again and loosen monetary policy. This came on the heels of a similar move from the Fed which is now likely to reduce the Fed funds rate by 25bps at the next decision point, and quite possibly another 25bps soon after. Some forecasts indicate a further cut but this is in our view unlikely.

So, the monetary war rides neck and neck with the trade war as countries and regions now add stimulus back in and cut the global tax that is higher interest rates. What is stunning is that plenty of 10-year government bonds around the world are in negative yield territory meaning that investors holding the debt are paying to hide in the perceived safety of these sovereign issues. In fact, JP Morgan research tells us that the share of global government bonds trading with a negative yield has risen to 29%, its highest level since October 2016. In Europe, that share of negative yielding government bonds rises to 48%.

The rally in bond markets usually balances with a fall in equity markets as the slower growth indicators have a divergent effect on both asset classes. Why both bonds and stocks, and gold too for that matter, have all rallied together presents a conundrum for the future allocation in portfolios. Which asset class will change direction to return the standard paradigm? Probably neither to any great extent is the answer. It looks like the central banks of the world have turned dovish together and are about to add monetary stimulus in case the world is slowing too fast, and if that is the case then the adage "Don't bet against the Fed" springs to mind. It may not be QE like the early days of the GFC but investors know what happens when the central banks act in concert to loosen monetary policy. This is the reason all three asset classes are heading up whilst earnings are being revised down. Apart from the counterintuitive and somewhat perverse direction of stocks when the signals are negative these days there is a possibility that such actions won't work like they used to. Interest rates cannot be cut as much as before and in some regions (Europe, Japan) there is way less room to manoeuvre. Could asset purchases restart? Quite probably.

This is a neat segue back to currency wars. In a slowing economy with a trade war running, it makes sense to weaken your currency. This is the unspoken tactic of all the central bankers today and we can expect to see a race to loosen policy and devalue currencies until such time as the GDP growth rates start to pick up. If the Fed fails to cut rates by 50bps over the next quarter the dollar will probably rally and equities may take a bath. A stronger dollar will hurt emerging market economies as well, much like we saw through 2018, and which we would rather not see again. The implication therefore as we head into the second half of the year and with Fed decisions imminent is to improve the strength of the model with a re-allocation of more sensitive equities such as EM and Asia into core MSCI World, add some cash and gold to the weightings and be prepared for a little more volatility as the markets digest the Fed announcements, the progress after the recent truce agreement at the Osaka summit of the G20 nations and hopefully better, not worse, PMI readings and earnings forecasts in the corporate sector.

On balance we still favour remaining invested in a balance of higher quality equities and shorter duration fixed income, gilded with a small but growing allocation to precious metals. Europe (and particularly Italy) is prominent on the radar as we continue into the second half, whilst the Iranian tensions cannot be overlooked even if at this stage it seems to be more smoke than fire. An oil spike due to closures in the Straits of Hormuz or further military versus oil tanker action would be a trigger for changes to the allocations.

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In summary, the picture is not as clear as it could be, but it is also not as dark as the media sometimes makes out. Global growth is sustainable, price to earnings ratios are not far off the long term average and if rates move lower there is support in place if needed. In the meantime dividend yields are attractive relative to cash rates and more so recently compared to fixed income so investors will be paid to hold their nerve. Improving the quality of the model portfolios at this point is prudent until the global picture looks clearer and after a welcome rally in markets to the mid-point of the year.

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