MitonOptimal

COMMENTARY

1st July to 30th September, 2019

The traditionally quiet northern hemisphere Summer proved a somewhat more eventful period for financial markets than normal. Interest rate cuts in the US (twice) and Europe, a resumption in the ECB's asset purchase programme and the pronounced shift in narrative from Central Bankers confirmed that the direction of Western monetary policy had moved far beyond the "mid-cycle adjustment" previously described by Federal Reserve Chairman Jay Powell. Meanwhile, a devaluation that pushed the Yuan through the symbolically significant CNY / USD 7.00 level signalled a further deterioration in international trade relations that, in spite of the main protagonists' claims to the contrary, show little prospect of improving any time soon. There were also major disruptions in global energy and US money markets when attacks on Saudi oil installations took out 5% of the world's refinery output and a shortage of overnight liquidity within the US banking system prompted emergency intervention by the US authorities.

All of which made for a volatile quarter across all asset classes. Core government bond markets recorded healthy gains, with the temporary inversion of yield curves in the US and UK reflecting growing concerns over a steady flow of data that points to a synchronised slow-down in global economic growth. In the equity space, a minimal change in the global developed market benchmark in USD terms gave little indication of the intra-period volatility or dramatic sector and style rotation that were a prominent feature of the period under review and translated to modest gains for Euro- and Sterling-based investors. Elsewhere, with the notable exception of precious metals, there was widespread weakness across the range of commodity complexes.

Equities

Index	Q3-2019	YTD
MSCI World ($)	+0.08%	+15.72%
MSCI World (€)	+4.26%	+21.55%
MSCI World (£)	+3.37%	+20.01%
MSCI World (local ccy)	+1.07%	+16.57%
S&P 500 ($)	+1.19%	+18.74%
FTSE UK All Share (£)	+0.12%	+10.52%
MSCI Europe ex-UK (€)	+2.66%	+17.97%
Japan Topix (¥)	+2.36%	+6.27%
MSCI Asia ex-Japan ($)	-5.34%	+3.55%
MSCI Emerging Markets ($)	-5.11%	+3.65%
MSCI Emerging Markets (€)	-1.14%	+8.87%
MSCI Emerging Markets (£)	-1.98%	+7.49%

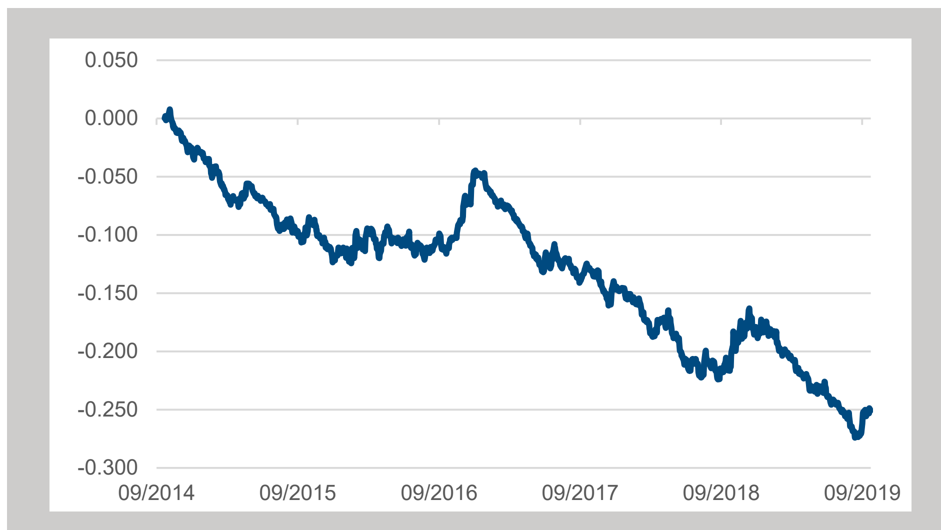
Source: Bloomberg

Not unlike the oft-used analogy of a duck's smooth progress over water, the apparent lack of movement suggested by the MSCI World Index's quarter-on-quarter (USD) gain of just 8 basis points obscured a fair amount of hectic activity beneath the surface. After a quiet start to the period, markets fell sharply at the beginning of August, when a worrying escalation in the ongoing trade war saw China halt purchases of US agricultural products and weaken its currency in response to yet another announcement of US tariffs on Chinese goods. The resulting near 5% fall in the aforementioned global benchmark was accompanied by a spike in volatility that sent the VIX Index, which measures implied volatility of the S&P 500 Index, back up to levels last recorded in January during the aftermath of the Q4 sell-off.

Although markets (happily) suffered little in the way of further downside, volatility remained at elevated levels throughout the month, with the US markets' ten daily moves of +/- 1% during August being the most since February 2018. Improved sentiment, helped at least in part by the scheduling of a visit to Washington by Beijing trade officials in October, lifted markets during the period's latter stages back to the top of their 12-month range.

Concurrent with the volatility described above were sizeable shifts in relative performance at sector, style and capitalisation levels. Arguably the most noteworthy of these – and certainly the one that generated the greatest amount of noise among commentators and strategists – was the surge in popularity of value stocks during the quarter's latter half. While this generated a good deal of enthusiasm from proponents of an investment style that has been out of fashion for most of the past decade, sceptics were quick to highlight the numerous instances of similar, but ultimately unsustainable, mini revivals during this time.

MSCI AC Value vs Growth

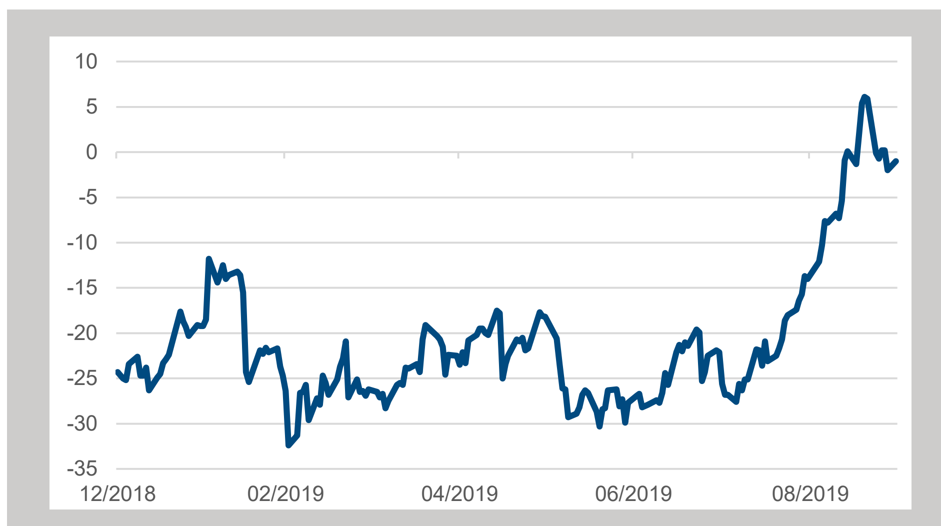


Source: Bloomberg

In terms of economic news flow, markets' movements played out against a backdrop of largely weaker data. GDP prints of +2.0% for the US, +0.2% in the Eurozone and +6.2% for China all represented a declining rate of activity versus the previous quarter. The monthly Purchasing Manager surveys, meanwhile, pointed to a likely continuation in this direction of travel, with the composite indices in both the US and Europe, at 50.7 and 51.8 respectively drifting further towards 50, which signifies the threshold between expansion and contraction (*stop press:* September's Eurozone release showed a dramatic fall to 50.1, with the manufacturing component hitting a 7-year low of 45.7). On a more constructive (or perhaps less negative) note, the corresponding report for China suggested a more stable outlook with a figure that held steady at 53.0.

If there was a positive take-away from the seemingly relentless stream of softening data, it is that, as evidenced by the strength in the Citi Global Economic Surprise Index, it was for the most part not as bad as had been forecast.

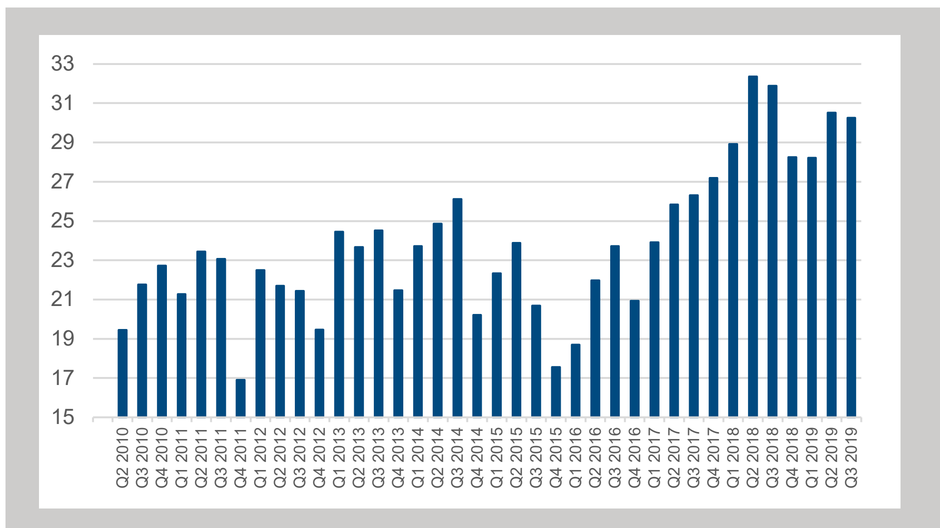
Citi World Economic Surprise Index



Source: Bloomberg

That perhaps explains equity markets' apparent indifference to the increased likelihood of recessionary conditions that have been manifested in the shape of sovereign bond yield curves and further suggests that faith in Central Banks' and governments' ability to stave off such an eventuality remains intact. Whether that faith is misplaced - and one gets an eerie sense this it is likely to be tested in the not-too distant future – and implies widespread complacency on the part of investors' remains to be seen. In fairness, however, both reported earnings, which, albeit they are backward looking, have remained commendably resilient in spite of macro data, and the continued healthy level of M&A activity run counter to a bearish narrative. As a result of that resilience in earnings, valuation indicators such as price / earnings, price / cash flow and price / book, have not changed a great deal and with prevailing levels that correspond (give or take) with ten-year averages are not, as a consequence, at historically excessive levels. Needless to say, we remain alert to signs of any change in corporate fundamentals, but for the time being retain "normalised" levels of equity exposure within our portfolio models.

MSCI AC World Index Quarter-on-Quarter EPS (USD)



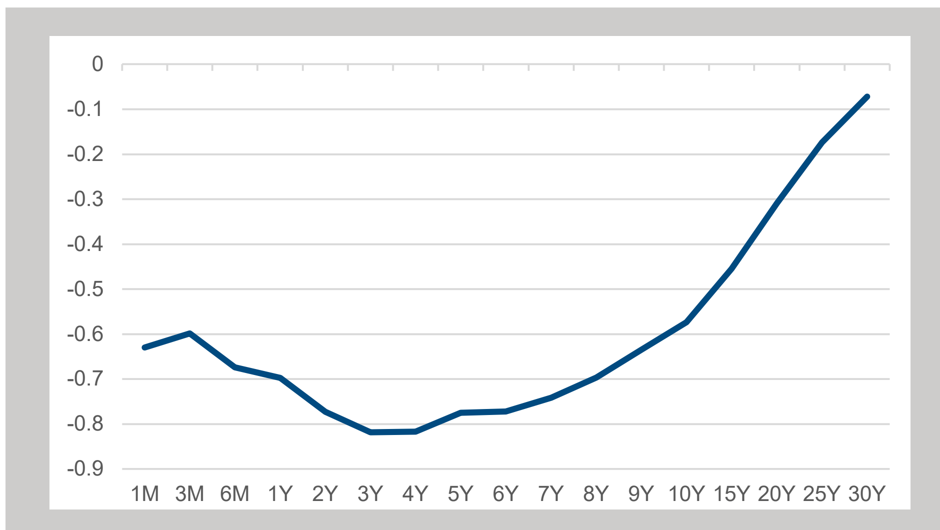
Source: Bloomberg

Bonds

As alluded to above, the performance of and movements in core government bond markets portray a less optimistic outlook for the global economy, with yields tracking lower and maturity curves signalling a heightened risk of recession. In a continuation of the trend that began in Q4 of 2018, sovereign yields maintained their downward trajectory: the US 10-year benchmark Treasury touched a 25-month low of 1.46% before closing at 1.67%, down 35 basis points (bps) over the period. A similar pattern saw the corresponding German and UK rates reach respective all-time lows of -0.74% and 0.41% and end the quarter at -0.57% and 0.48% (-24 bps and -44 bps). In market terms that translated to gains of 2.40% for the Bloomberg US Treasury (>1yr) Index and +2.13% for the Bund equivalent and a whopping +6.55% for Gilts.

If the size of these yield movements were not a strong enough indicator, the inversion of the US and UK maturity curves for 5 or 6 days straddling the end of August and beginning of September sent a clear message of bond markets' expectations that the odds of a recession had shortened further. Given their respective trading histories thus far, it was perhaps inevitable that the US and UK 2-year / 10-year yield spread would turn negative at some point, which may explain why the reaction of investors and commentators seemed somewhat muted when compared with previous occasions when the mere threat of an inverted yield curve had elicited a far more animated response. Interestingly, although economic news flow from the Eurozone - and in particular, Germany – points to a far greater likelihood of recession than elsewhere, the fact that the German yield curve maintained its positive (upward-sloping) profile could be viewed as something of a puzzle. That anomaly can perhaps be explained, however, by the fact that, as the result of movements in that particular market, every single German government security in issue (all €750 billion of them) traded at negative yields at the quarter-end.

German Bund Yield Curve (%)

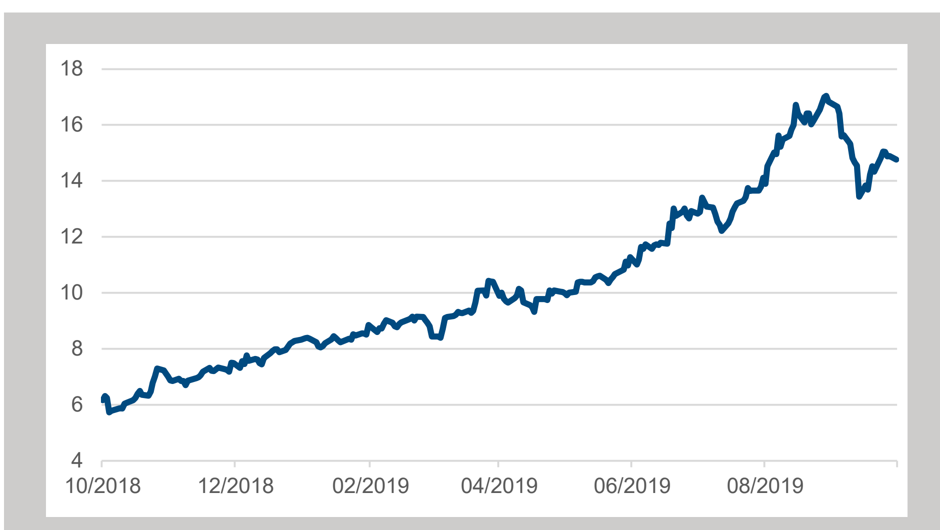


Source: Bloomberg

Continuing the theme of contradictory market signals, the performance of corporate bonds showed little indication of the same level of concern over economies' direction as that implied by the price action in core sovereign debt. Indeed, although yield spreads barely moved throughout the credit spectrum, the small changes that did take place over the quarter resulted in wider investment grade corporate spreads, while those for high yield borrowers tightened. Elsewhere, the yields on Emerging Market debt also narrowed in relation to their developed counterparts.

In a financial world within which the mention of numbers in the hundreds of billions and even trillions when related to the scale of companies' market capitalisations or Central Banks' balance sheets and asset purchases has become so commonplace, it still seems remarkable to this writer that, as at the end of the quarter under review, the total value of debt securities trading at negative yields stood at almost USD 15 trillion (by the same token, it is equally absurd that an index has been created to measure that number! The preponderance of debt that actually costs money to own - never mind the amount with negative real yields – when juxtaposed with investors' demand for income goes a long way to explaining the relative stability in credit spreads and, for that matter, why equity markets have not reacted more negatively to the reported trend in macroeconomic news flow. It also explains why, despite those lower nominal rates of return, we have maintained both the level and shape of our models' exposure to bond markets.

Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value (USD Trn)



Source: Bloomberg

Currencies

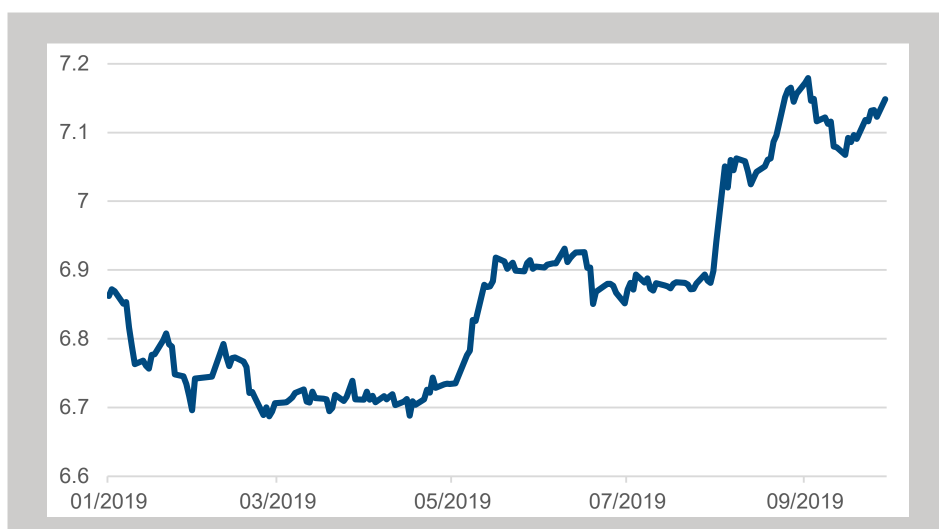
A series of four sharp upward moves, punctuated by partial reversals and periods of consolidation left the US Dollar up 3.38%, as measured by the DXY Spot Index, which ended the quarter at its highest level since May 2017. Of the 16 major currencies listed by Bloomberg, only the Taiwanese Dollar eked out the smallest of gains in USD terms, while the Brazilian Real (-7.37%), South African Rand (-7.15%), New Zealand Dollar (-6.82%) and Norwegian Krone (-6.11%) headed the long list of losers, among which Sterling and the Euro were down 3.20% and 4.13% respectively.

DXY Spot Index

Source: Bloomberg

As mentioned earlier, arguably the biggest story in the world of forex involved none of those major currencies. The decision by the People's Bank of China (PBoC) to devalue the Yuan in retaliation to new US trade tariffs saw the Yuan trade above CNY / USD 7.00 for the first time in 11 ½ years, inciting howls of protest from within the White House (in fairness, Mr Trump had a point) and in due course prompting the US Treasury to officially designate China a currency manipulator. That initial re-set was followed by further weakness - all down to market forces, according to the PBoC - and left the Yuan 3.94% cheaper in USD terms over the quarter. Given that the size of its surplus with the US means that the options available to Beijing in the way of further trade sanctions are pretty much exhausted, unless relations between the two countries improve dramatically, it seems highly likely that we can expect further depreciation of the Yuan over the coming months.

CNY USD Exchange Rate



Source: Bloomberg

Though not strictly currency-related, another notable event during the period under review occurred when the Federal Reserve was obliged to step in to support the US repo market to the tune of USD200 billion over a 3-day period to satisfy banks' demands for overnight cash. Annual corporate tax payment deadlines and a coincident Treasury bond auction were both cited as reasons for the shortage, but it does raise questions over the level of liquidity in the US money market and on corporate balance sheets and further suggests that, all things being equal, US monetary policy will remain looser for longer.

Commodities

The energy market also suffered its own a "black swan" event in mid-September with the bombing of two Saudi Arabian oil instillations that caused massive ("the worst ever") disruption to global refinery output. At the zenith of the panic that ensued, the front month future contract for Brent Crude was up more than $21 per barrel (bbl), or +18.7%, from the preceding night's market close, the impact of which reverberated right across the range of asset markets. Happily, this disruption proved short-lived, as in the first instance, both the Saudi and US governments announced that they would tap their strategic reserves to whatever level was necessary and, remarkably, all of the 7 million barrels per day output at which the plants were operating at the time of the attacks had been restored by the month-end. In fact, Crude Oil prices closed down over the quarter, with Brent lower by $4.55 bbl (-7.13%) and West Texas Intermediate by $4.40 bbl (-7.53%) at $59.25 and $54.07 respectively.

With the exception of a strong increase in the price of Nickel due to supply side pressures, the only area of the commodities market to show positive performance over the quarter was the precious metal complex. Though eclipsed by the improvements in Silver (+11.21%) and Platinum (+5.97%), the gain of 4.47% in the spot price of Gold (to $1,427.39 per ounce) extended its winning run to four consecutive calendar quarters (the best for eight years), while the peak price of $1,552.42 was the highest recorded since April of 2013. With the outlook for Gold continuing to look favourable from both a fundamental and technical perspective, we anticipate maintaining our models' exposure at current levels for at least the time being.

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