Weekly Market Comment

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Global stock market trend since Q1 2016; Source: Bloomberg

End of a stormy first quarter

Investors might think it appropriate that the first quarter of the year should end with a damp Easter bank holiday weekend (at least in the UK). After a pleasing last quarter of 2017, investors enjoyed what we refer to as a 'melt-up' in stock markets during January. Global growth had picked up markedly into the year end, and the expectation was that this would continue for most of 2018, boosted by US corporate tax cuts.

As more and more US retail investors re-entered into US equities, the professional investment community was swaying between trying to rationalise the increasingly lofty valuations with the growth outlook and warning that the ever-higher highs were pushing stock markets into dangerous 'bubble territory'.

In the end, the melt-up party was brought to an end by concerns that an overheating economy would push inflation and, in its wake, interest rates higher and more quickly than anticipated. Interestingly, wider market commentators only started to notice the slowing economic momentum after the first sell-off round, which swiftly led to the second round we experienced only last week. It is somewhat ironic that the second wave was on the back of the exact opposite concern to what triggered the initial correction at the beginning of February – slowing, rather than overheating economic conditions. Once euphoria and overconfidence has left the stage, the resurgent volatility in markets can be triggered by all sorts of concerns that would previously have been quickly dismissed.

In the meantime, central banks demonstrated that they were not inclined to overreact to inflation edging back towards more normal levels of around 2%. This, together with the moderation in the pace of growth, led to the much-watched longer term US bond yields ending the quarter well below the 3% watershed – the level which some had feared would cause bond markets to start misfiring and upsetting financial markets more broadly.

The rapid recovery from last week's fall tells us that stock markets still have legs. From our perspective, this makes a lot of sense, given global growth rates remain healthy, just not worryingly frothy. So why do we remain been underweight equities then? Well, as regular readers will know, we anticipated the return of volatility, and felt we would spare investors as much of the unpleasantness as we can. That is, without jeopardising the long-term return benefits of being invested at least. After all, given that markets broadly track the economy (which is still growing steadily), markets could resume the uptrend earlier than we anticipate.

The challenge of the coming quarter will be to foresee market reaction to the changing (but broadly normalising) environment, as well as the timing of those reactions. Macro-economic data flow over the coming weeks will be as important as the Q1 corporate earnings reports, which start to come out towards the end of April. Unfortunately, there are a number of additional factors which will make it difficult to make investment calls one way or the other with high conviction.

As laid out above, overshooting economic growth momentum no longer poses a particular threat, but growth remains strong enough to warrant expectations of gradually rising interest rates and bond yields. This in turn should prevent valuations from running away, as the competition of fixed interest bond yields returns.

However, more difficult to assess is the likely impact of the end of abundantly cheap capital. After a decade of ultra-low cost of capital, we must expect that it has, in instances, been allocated less efficiently than can be expected when it is more scarce. We therefore cannot be entirely sure how the corporate sector will cope under the higher burden of interest payments – though economic growth should soften the impact. We should expect more defaults in companies who were either kept afloat by cheap credit for longer than their underperforming businesses would have normally permitted, or overloaded on debt in the expectation that the 'old normal' would never return. This will bring back memories (and fears) of the credit crunch, but defaults from underperforming firms have always been part of a functioning economy which, by its nature, reallocates scarce resources to the most beneficial use available.

We had noticed this gradual tightening of money supply towards the end of last year and, since we know (and were around) when this happened during the last 1/3 of previous economic cycles, we projected that the runaway markets would sooner or later come to their senses. As a consequence, our more cautious portfolio positioning has meant our investors will have suffered smaller setbacks over the first quarter than they would have if we had stuck with the longer-term asset allocations. Nevertheless, 2018 returns are, thus far, slightly negative in lower single digit numbers across the spectrum of profiles.

While shorter-term setbacks like these do not tend to make too big a dent for investors who have already 'banked' a couple of years of positive returns, it is painful for those who have only recently taken the step to invest. I can feel the pain and I am never happy at the end of a negative quarter. However, in this instance, the continuation of economic growth and the generally positive outlook

Source: political cartoon gallery in Putney, 27 March 2018

(despite the occasional political blow-out) for the global economy gives us fairly high conviction that, over the medium term, returns will be back in positive territory for 2018. Over the shorter-term, however, volatility will continue to reign. While unpleasant, it is also a helpful mechanism to purge unhealthy market developments and help capital markets to adjust gradually rather than postpone the adjustment to a changed set of valuation variables.

As such, we were all but surprised by the sector rotation we witnessed over the past week, with tech stocks like Facebook, Google and Amazon turning from leaders to laggards. Again, regular readers will remember various articles last year in which we expressed our expectation that this backlash would happen. As such, we are pleased that the positioning against this event which we adopted in December last year has now come to benefit.

US-China trade war: about trade or about war?

Following Friday's big selloff, US equities faired relatively well this week. Monday saw the biggest one-day rally in US stocks since 2015, while Tuesday and Wednesday saw things quiet down, with only tech stocks remaining unloved. All in all, it represents a significant bounce back from what was a material downturn in stock markets last week. Predictably, top of the list for explanations from the financial commentariat was a dampening of the apparent 'trade war' that was brewing between the world's two largest economies: the US and China.

Last week, President Trump announced tariffs on around $60bn of Chinese exports to the US, threatening an import tax of 25% on key technologies. The Chinese were quick to up the stakes themselves, threatening tariffs on $3bn of US goods and even suggesting that they could sell US treasuries to defend their interests. The latter could develop into quite a threat for the US government, particularly as the Trump administration is moving towards higher fiscal deficits – albeit China would lose out on falling bond prices as well.

But this week saw things turn around markedly. On Monday, it was reported that the two countries had begun quiet negotiations on many of the US' gripes with China. The Trump administration requested that China reduce its tariffs on US automobiles and give American companies greater access to its financial markets, as well as work to reduce the US' trade deficit with China by $100bn by the end of the year. Chinese officials responded quickly to these requests, with Premier Li Keqiang saying that the government would treat domestic and foreign firms equally, stop forcing foreign companies to hand over their technology and strengthen intellectual property rights. Sticking points remain – such as the requirement that foreign firms form joint ventures with domestic firms – but the speed of progress and expression of intent has definitely alleviated concerns that an all-out trade war is looming.

Even before these negotiations, many commentators had doubted that things would escalate to dangerous levels. The response of the Chinese last week was mild, scaring American pork farmers but refraining from hitting the US where it hurts. The list of tariffs China published on Friday excluded key areas like soybeans, sorghum and Boeing aircraft. And the $3bn figure is a drop in the ocean for the US economy. Even on Trump's part, measures could have been worse. The $60bn targeted by the administration translates to 0.25% of Chinese GDP. On Sunday, even before the negotiations were revealed, the Guardian called the trade dispute "a game of paper tigers."

So that's that then. Trump's tough talk on China has brought them to the table and allowed the US to get the concessions they wanted. So much for a trade way, right? If we take equity prices as any indicator, that's the view of markets at least. But we think there might be a lot more to this story yet.

In our view, the crux of the issue is what these trade tensions are really about. Is it a feud between two trading partners over the perceived unfairness of the actions of one (as the 'deal-making' aspect of Trump's policies suggests)? Or is it a duel between the old heavyweight champion and the new challenger? That is, a confrontation between two empires to be played out on economic, political and maybe even military grounds over the coming decades.

If it's the former, disputes are negotiable and have a defined end point. It's in both parties' interests to find a solution which can keep the trade relationship – the biggest between any two nations – strong. But if it's the latter, as the US' labelling of China as a "strategic competitor" suggests, it's winner-takes-all. In that case, as with the cold war, there can be no resolution that will keep both sides happy.

In China, it doesn't look like the leadership wants to launch a play for global domination, as their mild tariff response and quickness to compromise suggests. Nor would they be wise too, considering the damage it would do to their economic, technological and military development. In the US, things are more complicated. On the one hand, one gets the feeling that talk of tariffs and unilateral action is all just part of Trump's "art of the deal". His focus on China's "unfair" practices and on getting back American industrial jobs supports this. On the other, what Trump represents – a growing antagonism towards globalisation and global rivals – suggests there is more to the dispute than anger at the Chinese 'breaking the rules'.

The ascendency of right-wing nationalists to foreign policy positions speaks to this point. John Bolton, Trump's new pick for National Security Adviser, is an unreconstructed conservative war-hawk who has advocated pre-emptive strikes against Iran and North Korea. There is no doubt he would pursue a harder line against China if he thought they presented a challenge to American global power. His ilk have become the norm in Washington's foreign policy circles, which suggests China's prominence on the global stage will become more pressing for the US leadership. It needs to be said, however, that such issues are inherently tied up in the goals of each administration, and could well change as quickly as the next Presidential election.

Which situation we're in isn't decided yet. It depends on the actions of both current and future leaders of both nations, and goes far beyond what Donald Trump does, says or tweets. But nevertheless, the popularity of Trump's hard-line stance on China is indicative of the US' changing views. Where the world's second-largest economy was once a productive partner in propelling global growth, it is now a serious political rival. Of course, rivals can work together for mutual gain – as the size and importance of the US-China trade relationship shows. The question to consider is whether that mutual gain is more valuable than the shift in the balance of power that comes with it.

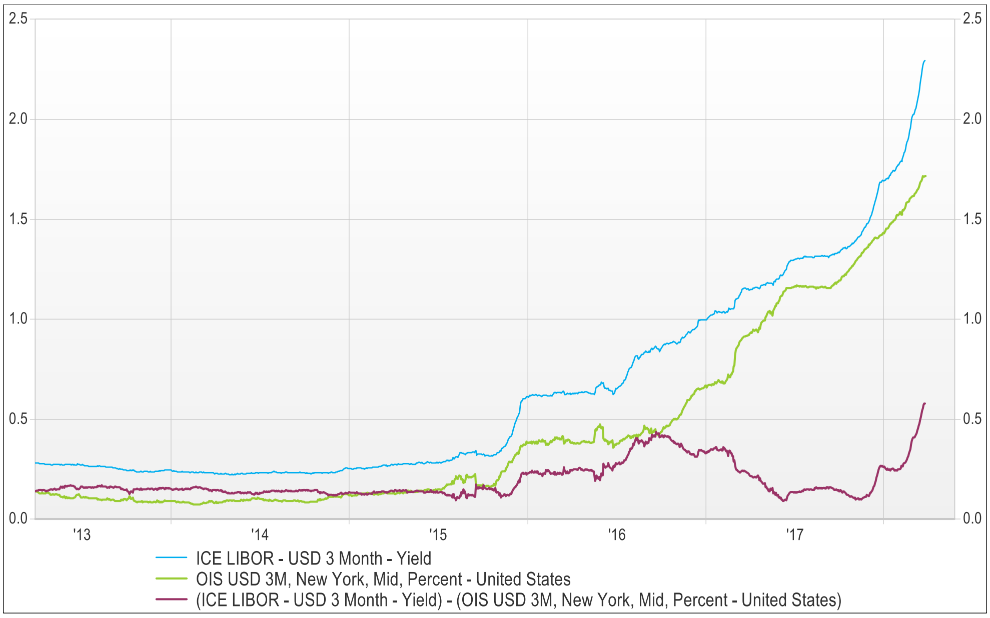
For now, both sides seem to want to settle. That's a positive for the global economy, not just because it stops harmful tariffs but because it could force China to change its ways. Many Chinese trade practices really don't play by the World Trade Organisation (WTO) rules of the developed world, and the Trump administration does have a point that still trading as an emerging market, the status under which it joined the WTO, is no longer appropriate for the world's second-largest economy. As long as we're in the 'deal-making' scenario outlined above, markets should stay happy (about China, at least). As Andy Rothman wrote in the FT last month, for all Trump's complaints, China's entry to the WTO has been a boon for the US, China and the wider world in economic terms. Markets will thereby expect rational heads to prevail.

But in our view, they might not see the true breadth of this dispute, precisely because they're focusing on the 'rational' benefits each side gets from the trade relationship. The geopolitical balance of power is at least as large a factor to consider. While both countries gain economically by maintaining trade, China gains more political power by maintaining the status quo (by rapidly expanding their technology, military and economic and cultural influence). But by the same token, the US loses more power. Owing to their stockpile of US treasuries, economically China has arguably the stronger hand in trade disputes. But in global power terms, the US has far more to lose by letting the current setup continue. That could well mean the US will pursue a harder line in trade disputes than many would anticipate. We will 'Watch this space'.

Private equity valuations, a Canary in the LIBOR Coal Mine?

Recently, we have seen a lot of coverage discussing the "LIBOR-OIS" spread, what it means, what's driving it, and what it could lead to for the wider economy.

First, a reminder from last week: OIS – overnight indexed swap, is a swap based on the rate set by a central banking authority. In the US, this is the Federal Reserve (Fed). LIBOR (London interbank offered rate) is an interbank rate – the overnight rate at which banks lend to one another. This spread between OIS and LIBOR, or lack thereof, is used by many as a proxy for the health of the financial system, the idea being that, when all is well, this market is very liquid and any premium required to lend to major banks is at a minimum. Recently this difference has spiked:



Source: FactSet

There have been varying explanations offered, one being that demand for private overnight deposits with banks has fallen now that short term Government debt offers a more substantial yield. Another has been a fall in demand for these instruments overall, as companies begin to repatriate some cash from abroad rather than holding them in enormous reserves offshore, as has been the trend recently.

But forgetting what caused it, what will its effects be? LIBOR has been is a crucial benchmark rate for many derivative contracts. Importantly, it is the benchmark rate used for huge amounts of existing floating rate debt, whose rates are generally defined as “LIBOR plus x%”.

Some of the largest users of these types of debt are Private Equity firms. These firms can use different strategies to extract value but the main one is to buy businesses that throw off a lot of cash and stabilise operating volatility. That stabilises earnings which makes them more attractive to lenders. The cost of debt (the credit spread) then goes down, enabling the Private Equity firm to raise the return on equity by gearing up.

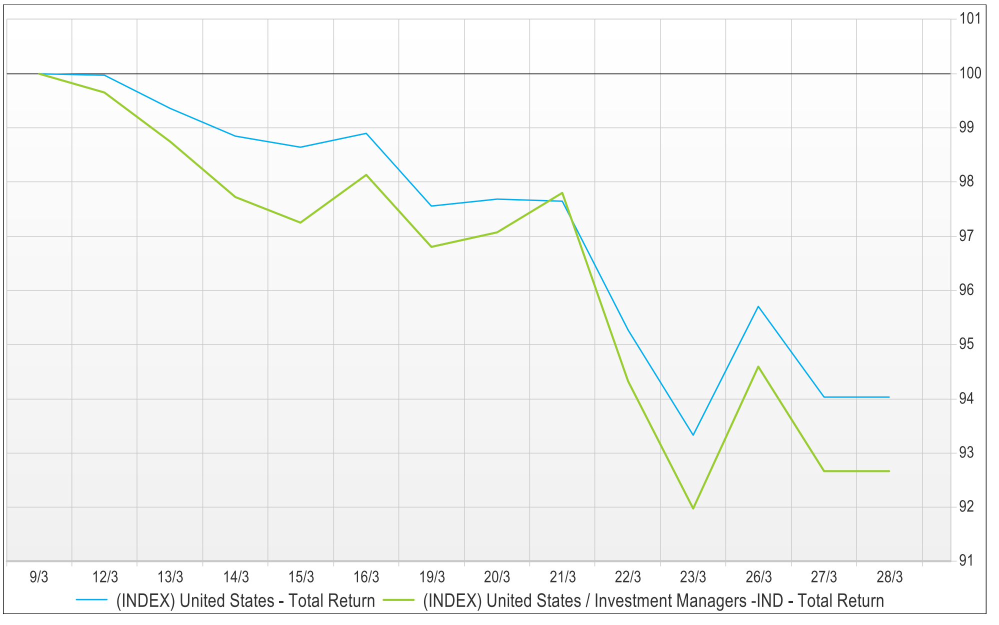
That leverage often has a floating rate of the “LIBOR plus x%” variety. We think that, if tightening monetary conditions causes problems, we might start to see signs of weakness in private equity-owned firms, as their portfolio companies’ financing becomes less secure. Their longer-term business model is also somewhat reliant on access to funding, as cheaper and more readily available debt boosts returns on invested equity and therefore IRRs (Internal Rate of Return - the most common measure of fund performance from which performance fees are generally computed). In turn, this boosts company revenues and earnings.

At a broad scale, due to their inherent exposure to financial assets, we would expect all investment managers (not just those in Private Equity) to exhibit a “beta” to the market – but that beta will vary depending on why the underlying assets have moved in price.

Managers’ revenues and earnings are almost always linked to the gross value of the assets they manage. If the earnings grow in those companies they own, the values of those companies will rise and so their own earnings will rise in line. That means the beta to the market should be 1.

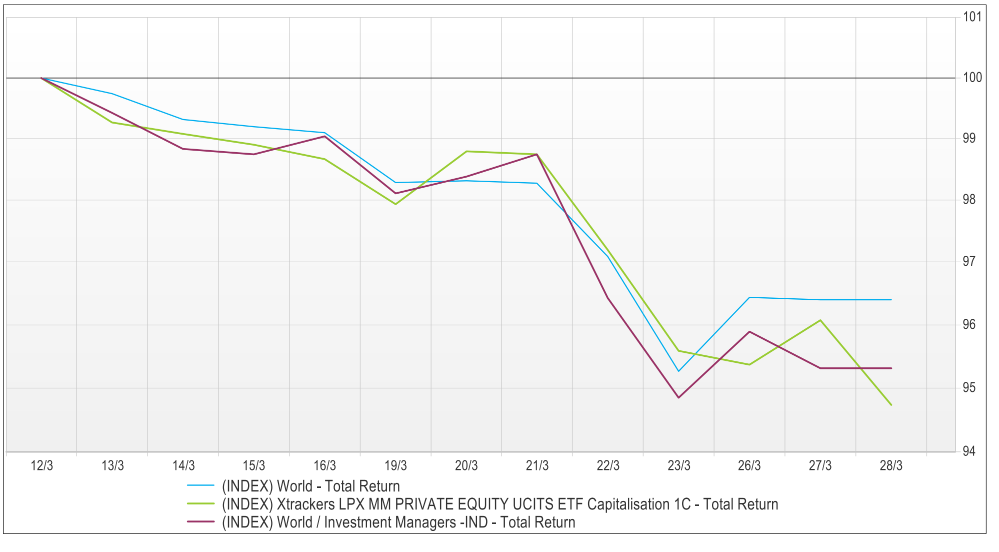
However, if it's the valuation of the underlying companies' earnings that changes, the gross value of those companies change, which affects the earnings of the investment manager – and the investment manager's valuation will probably change as well. That leads to a beta of more than 1.

Recent moves in the market, particularly in the US, have been due to a cheapening in valuations, rather than a fall in earnings expectations. On that basis, investment managers should underperform, and that's what seems to have happened.



Source: FactSet

But if we want to see if there is more of an underperformance in firms who rely on access to cheap financing, as has often been the case lately, there's an ETF for that. The DB-x Tracker shown below looks to track performance of businesses whose main purpose is private equity.



Source: FactSet

Assuming markets are close to efficient in this particular industry, it would seem that these companies are suffering no more than their listed equity counterparts.

Even listed Private Equity firms can be opaque. There are a number of unknown factors here such as the vintage of these companies' portfolios, their existing funding, the sectors, and even stock specific issues. We hope to do a deeper dive into the holdings of both listed and unlisted firms, and the implications for equity prices and on economies. In the meantime, in aggregate, their own share prices can help us get a feel for sentiment and hopefully reality for these business models.

According to this measure at least, the increase in the LIBOR-OIS spread seems to be a technical issue, rather than one which impacts the provision of debt to those who deal with it most frequently. We'll be watching the Private Equity share prices closely for any signs of change.

Have the tech 'superstars' lost their shine?

Is the recent sell-off in shares of the big technology firms merely a short-term blip or a signal of more permanent change? The answer to this question may shape the near-term direction of markets and long-term direction of the global economy.

Shares in the biggest tech stocks experienced their biggest combined one-day loss on Tuesday. Looking at valuations and historic share price performance, investors may have thought that these firms faced no competition; growth for the FAANGs (Facebook, Amazon, Apple, Netflix and Google) looked unstoppable. But that future and their valuations now face more uncertainty.

It is unfair to lump all technology companies together. Some produce hardware like Intel and some like Microsoft write software, while others sell advertisements to customers by using an individual's own data against them.

It may be hard to think of Facebook, Twitter and Google as advertising businesses and not technology businesses, but that is what they are. Facebook and Google derive 98% and 90%+ of revenues from ad sales respectively, and both firms now dominate the advertising sector. Collectively, Facebook and Google account for 25% of ***all*** ad sales both on, and offline worldwide. For Twitter, data licensing accounts for about 80% of profits.

Interestingly, the experience of the financial sector in 2007 provides a good analogy for technology stocks today.

The last bull-run was led by banks, powered by high leverage, mortgages and supported by easy regulation, until one day the music stopped. The S&P500 peaked in October 2007 and then fell 58%, finding a floor 17 months later in March 2009. Citigroup, Bank of America, Morgan Stanley, Goldman Sachs and JP Morgan were down an average of nearly 90% from their 2007 highs.

Today's "market generals" or leaders reside within the technology sector, as prominent Hedge Fund investor Eric Peters of One River Asset Management remarked. Like financials of 2007, tech stocks have had it good with high profit margins amid loose regulation. Since the lows of 2009, Facebook is up 413%, Amazon 2,102%, Apple 1123%, Netflix 5,349% and Google 586%.

Now the generals are faltering, as investors ponder the growth implications from any new data or privacy regulations, which could curb what a firm can do with a user's data. Without access to user data, they cannot deliver targeted ads or grow profits, which puts their lofty valuations under pressure.

But new regulations need not be the death knell of the current rally, merely the harbinger of change. For financials, MiFID I & II in Europe and Dodd-Frank in the US have led to higher costs of doing business, but have also created new opportunities, even if profitability is unlikely to match peak levels.

Likewise, with the technology sector, new regulations may not break current business models, but change is most likely in the air. Perhaps the era of personal data sovereignty is upon us and that too will create its own new opportunities; more open versions of social media may emerge. Maybe new regulation could eventually help provide investors with greater clarity over growth, even if growth rates are more modest than in the past.

As investors start to discriminate between companies and their business models, dispersions (i.e. the difference in the return on an individual stock versus the return on its index) are rising for those who might be impacted by new data rules from those least effected.

A business model can be thought of as the process by which a firm identifies its customers and profits from satisfying their needs. In some respects, business models are fundamentally linked to technological innovation, but a business model can be separable from technology. These decisions have a direct bearing on firm performance.

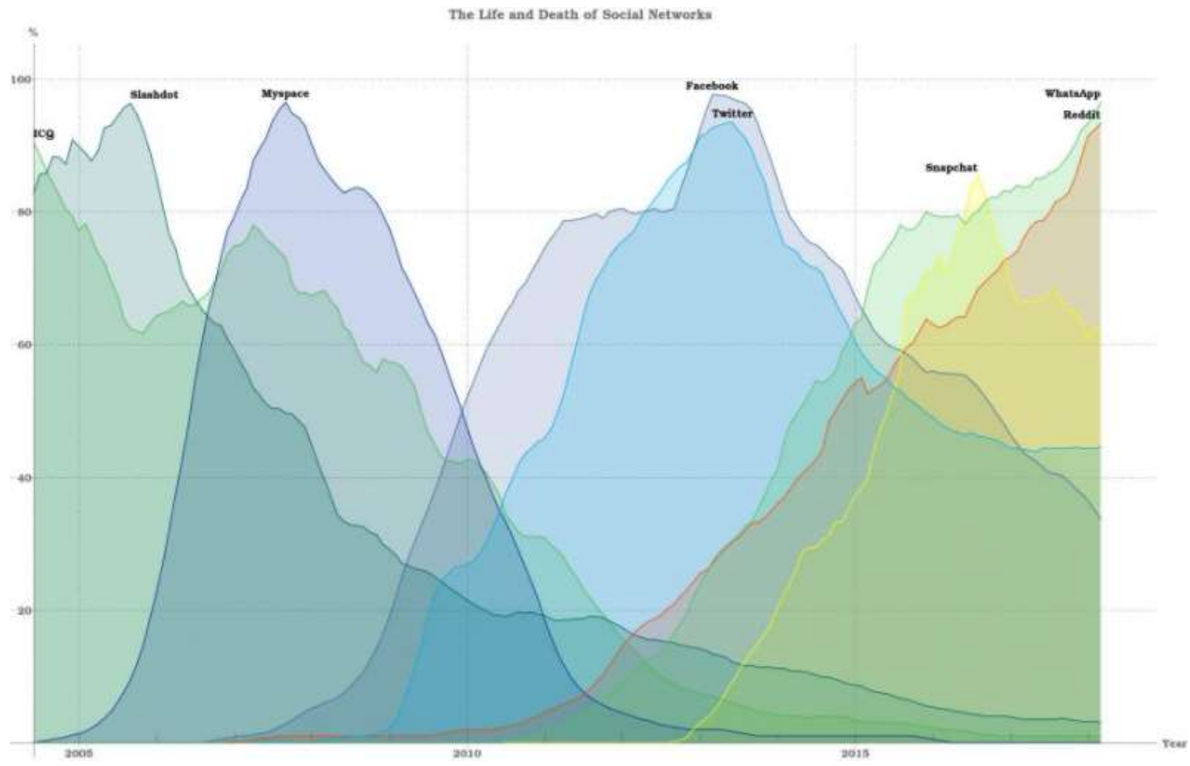
Technological developments can create new business models, as in the case of social media companies that trade customer data for user access. In other cases, innovation can occur independently, such as Japan pioneering “Just-In-Time” production in the 1980s. Business models and technology regularly interact – Amazon did not need to invent anything new, but it applied technology to book delivery and Easy-Jet copied the model of South West Airlines.

The launch of Google’s 2-sided search engine in 2003 was both a technological and business model leap. Google used dynamic Adwords to provide an interface with advertisers. That brought the large network effects, which resulted in increased customer satisfaction (as results consistently improved over time) and higher revenues for any given set of users on each side of the platform.

Cloud computing and the everything-as-a-service business model that emerged from it has drastically cut the time and investment needed to launch new products, while making it far easier to enter into new markets. These network effects are highly scalable, generating better cash flows and giving firms tremendous flexibility and options for growth.

This virtuous cycle enabled the FAANGs to continue pulling further ahead of the competition, creating effective monopolies. Facebook grew from a few students at Harvard to 1 billion users (about 17% of world population), while Google dominates global search via the web and runs an Android smartphone operating system that, if enabled, constantly collects data (location, etc) about a user for use by advertisers.

One interesting aspect of these businesses is that the everything-as-a-service business model relies on the trust that consumers and businesses have in the digital ecosystem. Without that trust, what is the true value of that system?



The graph above shows how user interest in various social media companies changes over time, via search interest on Google under the terms in the chart above, sourced from Google Trends.

The Facebook affair may have created an environment in which trust has been or is being eroded. What would happen to the ad revenues of Facebook if the #DeleteFacebook campaign successfully encourages users to delete their accounts? What would happen if anti-trust (monopoly) laws lead to a break-up of Amazon or Google?

The removal of monopolies, through regulation or otherwise, could lead to a renaissance of competition, given a more level playing field. Additionally, Facebook's data policies may even lead to the firm being excluded from Socially Responsible funds on the grounds of unethical behaviour.

Once trust and confidence in the unopposed growth of the FAANGs evaporates and users migrate to another platform or service (the now defunct Myspace – the forerunner to Facebook suffered such a fate) such businesses may face terminal decline, which can be hard to escape, like moths wandering too close to the light.

The question for investors is: what are the FAANGs worth without their monopoly positions and unrestricted access to customer data? How would an analyst value the worth of a firm's intangible assets (algorithms) or goodwill under those conditions? At the very least, we think investor confidence in the permanence of the FAANG monopolies has been dented. Maybe the social media emperor never had any clothes to begin with once users got wise to the fact 'they' are the product.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7091.7	2.0	139.1	↗
FTSE 250	19490.5	0.5	96.6	↗
FTSE AS	3910.4	1.7	63.5	↗
FTSE Small	5583.9	-0.6	-34.5	↗
CAC	5179.5	0.2	12.3	↗
DAX	12124.7	0.2	24.6	↗
Dow	24082.1	0.5	124.2	↗
S&P 500	2632.9	-0.4	-10.7	↗
Nasdaq	6524.0	-2.4	-158.2	↗
Nikkei	21159.1	-2.0	-432.9	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	12.7x	13.1x	17.1x
FTSE 250	2.8	14.6x	14.0x	17.0x
FTSE AS	3.9	12.8x	13.2x	16.6x
FTSE Small	3.3	9.8x	-	-
CAC	3.0	15.0x	13.8x	15.4x
DAX	2.6	11.9x	12.2x	16.9x
Dow	2.2	19.0x	15.7x	15.3x
S&P 500	1.9	19.8x	16.2x	17.5x
Nasdaq	1.0	24.7x	19.4x	20.2x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
SHIRE	19.2	SMURFIT KAPPA	-5.1
GLAXOSMITHKLINE	9.4	PRUDENTIAL	-4.0
FRESNILLO	9.4	INTERTEK GROUP	-3.4
MICRO FOCUS INTERN	8.2	STANDARD LIFE ABER	-3.4
CENTRICA	7.8	HARGREAVES LANSD	-3.4

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.40	-0.51	OIL	69.9	1.4
USD/EUR	1.23	-0.11	GOLD	1322.5	-0.3
JPY/USD	106.35	-0.55	SILVER	16.3	-0.6
GBP/EUR	0.88	-0.41	COPPER	302.4	0.1
CNY/USD	6.29	0.72	ALUMIN	2027.0	-2.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.349	-6.3	-0.09
US 10-Yr	2.752	-2.6	-0.07
French 10-Yr	0.719	-6.5	-0.05
German 10-Yr	0.496	-6.2	-0.03
Japanese 10-Yr	0.040	5.3	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	1.5
Weighted Average Interest Rate (BoE)	4.23
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel