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HOTTINGER

GROUP

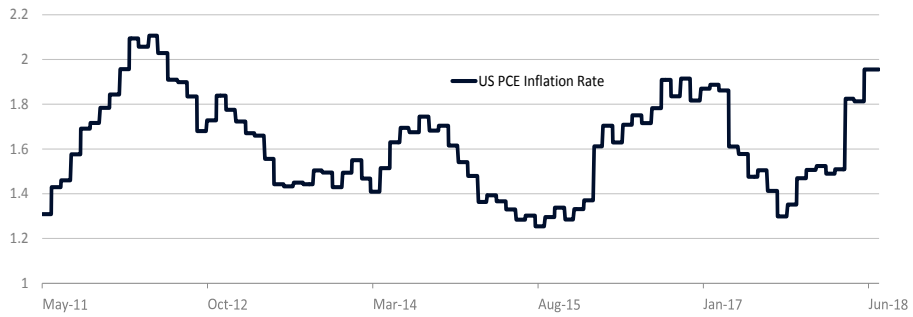
Family Office of the Year 2017
City of London Wealth Management Awards

GLOBAL INSIGHT

Overview

- In our **feature article,** we interview Hottinger's economic strategist Zac Tate to understand what the political crises brewing in Italy mean for the future of Europe.
- The European Union's failure to deal with division between nations over the euro and migration is acute in Italy, whose new government threatens the club's survival.
- The EU now needs to build a set of flexible and fair political institutions to change course.
- In our **Macro View**, we assess how monetary tightening in the United States has affected emerging markets.
- We raise concerns about rising levels of corporate debt across the world and how higher interest rates could create stress for a number of highly leveraged companies.
- A mild slowdown in China appears to have encouraged the People's Bank of China to ease financial conditions in Q2 2018, going against the grain globally.
- In the **Investment Outlook**, we note that the disparity between value stocks and growth stocks is approaching the peak similar to that seen in the Internet bubble of the late 1990s.
- We think that although the consensus is for the world to be heading towards the end of a bull run, a recession does not seem likely in the near term but more likely in 2020 or 2021.

US core inflation flirts with 2% again



Source: Hottinger Investment Management; Bloomberg

Inside this issue

Economic Highlights

- UK GDP rose by 0.3% in the month of May alone.
- The Shanghai Stock Index is down 20% since January.
- US core inflation reaches significant 2.0% level in June.
- ECB announces its intention to end its bond-buying scheme.

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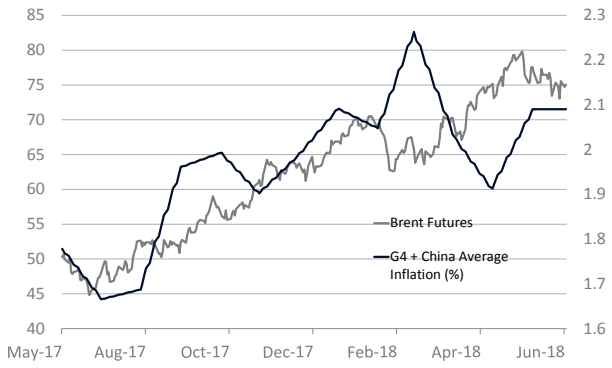
Based upon information available up to and including 17th July 2018

Key Issues in Charts

Rise in headline inflation is mostly about oil

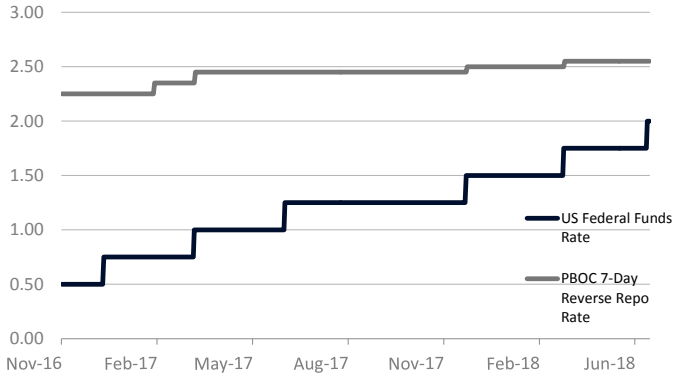


Source: Hottinger Investment Management; Bloomberg

- Oil prices have rising by two-thirds in the last year, with Brent Futures going up from $45/bbl in June 2017 to $75/bbl at the time of writing.
- Months of cuts in production by big producers such as Saudi Arabia and Russia are finally having the desired effect, particularly as US shale oil supply disappoints. Strong global growth has boosted demand.
- Together with the general recovery in commodities prices, higher oil prices are putting upward pressure on firms' costs, which are passing through to higher headline consumer inflation.

Has China stopped following the Federal Reserve?

- On the last four occasions on which the Fed raised rates, the PBoC, China's central bank, has raised rates on three occasions shortly after.
- This shows the extent to which the United States remains highly influential when it comes to managing global liquidity, as global-facing firms often need access to the US banking system and dollars.
- However, in our Macro View we comment on the recent change in direction of the PBoC as Chinese growth slows. Global coordinated tightening may be coming to an end.



Source: Hottinger Investment Management; Bloomberg

Federal Reserve approaches the 'natural rate' of interest

- The chart below shows the inflation-adjusted Federal Funds Rate (the basic interest rate set by the Federal Reserve, upon which so much of the global economy depends) compared with what's called the "Laubach-Williams Neutral Rate of Interest." This latter measure is a theoretical indication of where the inflation-adjusted (or "real") rate of interest would be if the economy is in a "fully employed" or healthy state.
- The chart suggests we are possibly reaching that point in the US, but it also shows that the Federal Reserve has a tendency to 'overshoot' Laubach-Williams neutral rate. Before each of the last four recessions in the US, the real Federal Funds rate has exceeded the Laubach-Williams rate, and there are fears that the Federal Reserve may move in that direction again.

Q&A: Why Italy's twin crises are existential for Europe

By Zac Tate, *Economic Strategist at* ***Hottinger Group***

The European Union is at an existential moment in its history. Never more than now do the continent's leaders need to agree what Europe needs for its stability and take the necessary actions. Specifically, how the bloc handles the twin political storms brewing in Italy will shape the continent's future. The Hottinger Group interviews its economic strategist to find out more.

Why is Italy at the forefront of Europe's ongoing political crisis?

Italy has seen barely any economic growth since 1999, compared to growth of roughly 15-25% in Germany, France and Spain between 1999 and 2016. In the Mezzogiorno, in southern Italy, unemployment is still close to 20%. Since Silvio Berlusconi resigned in 2011 and was replaced by Mario Monti, successive governments in Italy have been asked by the European Union to implement severe austerity measures to keep the country's high level of public debts under control. Yet many voters now feel that prolonged budget cuts have extended the bad economic situation in the country and done little to keep debt down, and they now want political parties that are willing to push back.

"Italy has seen barely any economic growth since 1999, compared to growth of roughly 15 -25% in Germany, France and Spain."

At the same time, Italy has been the point of entry for some 300,000 migrants by sea in 2016 and 2017. Italians criticise the European Union for insisting that migrants apply for asylum in the first country they enter; the EU's Dublin Regulation means that many migrants who would prefer to move on to different countries have to remain in Italy at great cost while their asylum applications are assessed. Italy has mostly borne the expense for this system, creating an additional sense of grievance at a time of economic distress.

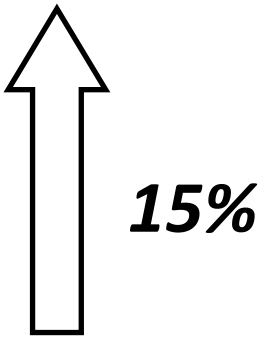
"Italy has been the point of entry for some 300,000 migrants by sea in 2016 and 2017."

In the last election in March, voters turned to two populist parties: the right-wing Lega Nord, which under leader and now Interior Minister Matteo Salvini pushes a tough line on migration; and the 5-Star Movement, which is proposing to increase public spending radically. The two parties won the support of just under 50% of the public, but in recent weeks their approval has gone up, with almost 60% of voters now backing the parties.

Is the euro to blame for Italy's economic problems?

The euro isn't solely to blame for Italy's poor performance. Low levels of tertiary education; a focus on traditional, low-growth industry; and questionable lending decisions within Italy's banks all play their part. Italy is also living with the legacy of building up large amounts of public debt in the 1970s and 1980s, during which there were big increases in spending on welfare, healthcare, and subsidies to households and firms.

However, in the 1980s, to meet the requirements of the European Monetary



"Italy's public debt to GDP ratio has grown by 15% since 2010."

System, the precursor to the euro, the Bank of Italy clamped down on high inflation by steeply raising interest rates, stopped directly funding public borrowing, and started issuing bonds to the private sector instead. These policies sharply increased the cost of servicing public debt.

Institutional features of the eurozone—namely, the low-inflation bias of the European Central Bank (ECB) and the inability of member states to issue and control their currency—place further constraints on Italy. Weak productivity growth in Italy has meant that it has had to keep its inflation rate close to zero in recent years to maintain competitiveness. This dampens business activity, and keeps the debt burden high. Italy's public debt to GDP ratio, which currently stands at over 130%, has grown by 15% since 2010, even though the country has been running primary budget surpluses.

So does Europe stand in the way of what Italy wants to do?

Partly. While reforms are needed in Italy, they also cost money. Italy needs to invest in retraining people who are unemployed and in the infrastructure for the industries of the future. Last month, the coalition partners proposed spending plans amounting to an increase of €125bn a year (or 7% of GDP), but they run up against two big problems that are to do with European institutions.

The first is that the plans are a clear breach of the EU's Fiscal Compact rules, which say that countries cannot run a budget deficit of more than 3% of GDP. If they insist on doing so they forfeit the right to assistance from the European Stability Mechanism and the ECB in times of crisis. Without an exemption from the EU, the Italian government will need to revoke the Fiscal Compact if it wants to put its spending plans in place.

Second, the ECB is ending its bond-buying programme. For the last three years, the ECB was the only net-buyer of Italian bonds. From next year, Italy will need to rely entirely on private markets to buy the new bonds it sells to fund its promises. Currently, foreign investors and domestic banks together hold 75% of Italian debt, while households hold less than 10%. Investors will want to see credible plans. Yet there are factors that have nothing to do with European institutions, and more to do with the viability of the spending plans and Italy's high historical debt burdens.

The new government's spending plans, which amount to borrowing of 7% of GDP per year, are a clear breach of the EU's Fiscal Compact rules.

As things stand, the plans will struggle to muster support. The proposals combine large tax giveaways with an increase in pensions and payments to the poorest citizens. Without a convincing narrative for how the programme would boost long-term growth, investors will make comparisons with the 1970s.

That means that if asset-rich Italian households are unwilling to absorb the new debt, the state may have to pay higher interest rates to borrow. In that event, Italy's public debt could quickly look precarious, creating stress in many of the multinational banks that hold Italian debt and possibly setting off another economic crisis.

Is the economic crisis linked to the migrant crisis?

There's a feeling that the coalition senses a tactical connection between the two. The government has softened its stance on its spending plans to calm the markets, but also because it can deflect attention to its refugee crisis, the other problem it was elected to address. Matteo Salvini, the new Interior Minister, is busy forming an alliance between Italy, Austria and Bavaria against immigration and refugees. Their ideas include expelling migrants that enter their states from other EU countries, potentially endangering the borderless Schengen area.

*Lega Nord's leader **Matteo Salvini** at the party's anniversary event.*

The two crises strike at the two key pillars of European integration: economic union through the euro and social union through free movement across borders. As a founding member of the European Union, Italy is a political heavyweight. The fact that Italy is exposed to problems that separately call into the question the legitimacy of both institutions radically increases the bargaining power of the government in addressing each issue.

How dangerous is the anti-migrant rhetoric?

What unites the emerging anti-migrant pact in Central Europe is a belief—first articulated in the eighth century, soon after the Battle of Tours—that Europe is exclusionary and defined in opposition to outsiders, and especially to Islam.

European leaders need to ask themselves whether they are willing to allow a corrosive and illiberal politics to expand in places like Italy as the price to pay for keeping the economic status quo, which places too much pressure on indebted states. The longer the economic problems last, the more tempting and dangerous Salvini's anti-migrant agenda becomes. Foreigners turn into novelist W. Thackaray's "fictitious monsters of the tale", undermining what we think are genuine European values: human dignity, equality and freedom within the law.

What needs to be done?

Many Northern European countries, including Germany, the Netherlands and Ireland are reluctant to move too far beyond the current rules. Northern Europe doesn't want what Angela Merkel calls a 'debt union' , which would exist if there were moves to forms of eurozone risk sharing that include deposit insurance, mutualised debt issuances and guarantees, and even inter-state fiscal transfers. Yet some of these are exactly the things that many other European countries, including Italy and France, want.

"Many Northern European countries, including Germany, the Netherlands and Ireland are reluctant to move too far beyond the current rules."

While Northern European states shouldn't feel responsible for the debt Italy built up in the 1970s, and while they may fear that Italy's latest fiscal stimulus could leave their taxpayers exposed, there remains the problem that the euro-

zone's rules currently do not meet the interests of some of its largest members.

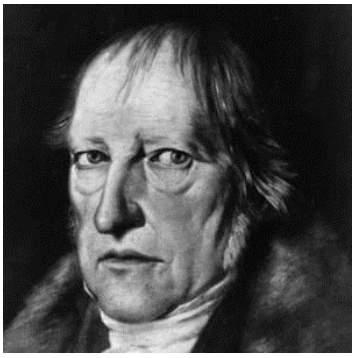
There is a way out that restores a fair balance. States in Italy's situation should be allowed to moderately breach the EU's budget deficit limits and increase spending, but funds must be used for investment purposes that raise the country's growth potential. If Italy were willing to accept EU oversight, the debt could be mutualised to keep borrowing costs low. The rules of the ECB should also be rewritten to allow for higher inflation, which would give troubled states more space to invest, boost competitiveness and address structural issues.

"States in Italy's situation should be allowed to moderately breach the EU's budget deficit limits and increase spending."

While such a deal maintains limits on Italy's sovereignty, it also imposes restrictions on other countries such as Germany and the Netherlands, whose export sectors structurally benefit from low inflation. It recognises the responsibilities that interconnected nations have to each other and acknowledges, as John Maynard Keynes first noted, that creditors in a monetary union have a greater ability to adjust, even if they can also choose whether or not they want to. Limits on sovereignty work in the service of political stability, which ultimately benefits everyone. It's the basis for successful international relations.

Is the future of the European Union in doubt?

Only if policymakers remain blind to the risks. So long as Europeans attach importance to their national identity—and surveys suggest that they overwhelmingly do—the EU will continue to have to deal with what German philosopher G.W.F Hegel called the "particular wills" of each nation, shaped by their unique historical experiences and evolving understandings of their own interests. This means that a particular framework of international rules that provides stability at one point in time can become a source of instability some time later.



"The EU will continue to have to deal with what German philosopher G.W.F Hegel called the 'particular wills' of each nation."

Such is the position for Italy, which derived some benefits from joining the euro but now finds itself in a rut. The rules need to change to reflect the new reality.

In the absence of a European demos, the EU will continue to evolve through crises that arise when the rules no longer work for everyone. That is not a sign of failure, but it does mean we must be aware that one size does not always fit all, be alive to the real and diverse lived experiences of national citizens, and build a set of flexible and fair political institutions to change course.

Zac Tate is Economic Strategist at Hottinger Group

Macro View

The fashionable view is to expect that the world economy will grow by almost 4% both this year and next, with emerging countries leading the way while the US and Europe expand faster than their long-term averages.

Whilst we think there is sufficient momentum within the system to keep conditions reasonably benign for the next 18 months, there remain many downside risks to growth—namely, the effects of changes in global monetary and fiscal policy, particularly from the United States; threats from rising levels of private debt, especially within emerging markets; and heightened political risk, including the prospect of an international trade war and the continued rise of nationalism in Europe.

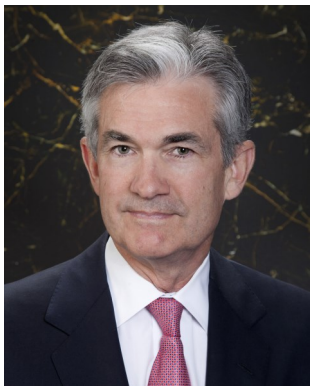
2018

4%?

United States—Core inflation finally comes through

There is little doubt that animal spirits abound in the United States at the moment. The labour market continues to tighten; according to Deutsche Bank, it now takes firms twice as long (31 days) to fill the average vacancy as it did in 2010. Firms are responding by making plans to increase investment spending, which should boost the contribution to growth from productivity. Consumer confidence has exceeded levels last seen before the financial crisis of 2007. There's a good chance GDP growth in the US could exceed 3% over the calendar year and for unemployment to fall towards 3.5%. In June, core inflation rose to the symbolically important 2% level, and herein lies the risk.

The Federal Reserve has a dual mandate to manage both core inflation and unemployment. It is looking at an economy that appears to be overheating, with big tax cuts and spending programmes amounting to $1trillion a year on their way, and believing that rises in core inflation could well continue.
The risk, however, is that the Fed overestimates the amount of interest rate rises the economy needs, and history tells us that raising interest rates too quickly is a precursor of recessions, as it was in the early 1980s, early 1990s and mid 2000s (see bottom chart, page 2).



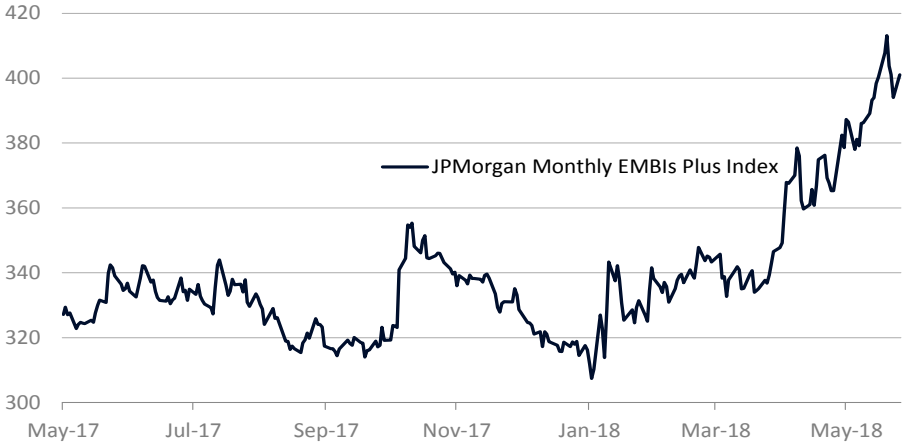
"The Federal Reserve has a dual mandate to manage both core inflation and unemployment."

The US sneezes and emerging markets catch a cold

US economic policy is often felt far and wide. The US dollar continues to underwrite the global economy and access to the American banking system is essential to companies around the world. The effect of higher interest rates in the US, an increase in supply of US Treasury bonds due to rising fiscal deficits and the reduction of the Federal Reserve's holding of Treasury bonds is to drain the world economy of dollars and weaken emerging market currencies. This puts stress on emerging market debt, much of which is issued in dollars, and pushes up financing costs for companies (see chart), a concern raised by

Indian Central Bank governor Raghuran Rajan in recent weeks.

Risk premia on emerging market debt rise in 2018



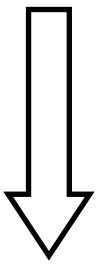
Source: Hottinger Investment Management; Bloomberg

Emerging market policy-makers have raised concerns about the direction of US economic policy.

It's especially an issue for those countries that have loaded up on cheap private-sector debt in recent years . In the last four years, according to the IMF, nominal private sector credit has grown by 140% in Cambodia, by 90% in Sri Lanka and by over 50% in China and Bangladesh. Firms in these places will watch developments in global monetary policy with concern.

China thinks again about tight money

Corporate debt is a particular issue for China, where outstanding credit represents over 150% of GDP and has grown rapidly over the last decade. With so much of global trade centred on China, developments there play an increasingly important role beyond the country.



50 basis points

...decrease in reserve requirements for Chinese banks.

For the last year, the People's Bank of China has been following the Federal Reserve by raising interest rates but it also has been curbing riskier lending by forcing banks to include their off-balance sheet lending onto their main accounts. This latter measure has raised borrowing costs, crimping investment and inventory spending by businesses. Meanwhile, weaker house price growth has weighed on consumer spending and cut-backs in government-funded infrastructure spending have dampened domestic demand. Meanwhile, touted US tariffs on over $200bn of Chinese exports would start to hit the external sector. Chinese growth slowed slightly to 6.7% in Q2, and the leading Shanghai stock exchange is down by 20% on January – a technical bear market.

The PBoC has responded by easing policy. Last month, it announced that it would reduce the portion of cash that most banks must hold in reserve by 50

basis points. This was equivalent to deploying 700bn yuan ($106bn) in the financial system, or nearly 1% of GDP. It's a sign that monetary tightening can choke off global trade more than policymakers are comfortable with.

Europe's debt problems have no end

Europe cannot sustain 3% annual growth, which was where it was running at the end of Q4 2017, so it was inevitable that things would fall back this year. Soft data measuring business sentiment point to annualised growth closer to 2.5% for Q2, which is still well above the European average.

And yet, Europe is not free of its own debt issues. While most observers are well-acquainted with the challenging situation facing many Italian banks– which hold high levels of domestic non-performing loans and public debt– there are growing concerns, first raised by Absolute Strategy Research, about the state of the French financial system.

France has been one of the stars of the great Eurozone recovery over the last two years, yet the share price of four of its biggest banks has fallen by over 20% since the start of year (Societe Generale Credit Agricole, BNP and AXA). France has surprisingly high levels of private debt–190% of GDP, and up by 17 percentage points in last 5 years. Much of this increase is debt financing by corporates, but households have been taking on more debt. Combined with France's high level of government debt and the exposure of French banks to both French and Italian public debt, there is good reason for concern.

"France has surprisingly high levels of private debt – 190% of GDP up by 17 percentage points in last 5 years."

The UK rebounds as Brexit looms

In early July, the Office of National Statistics released a monthly GDP series for the first time, showing that the British economy grew by 0.3% in May alone, compared to just 0.2% in the whole of the first quarter. A strong recovery in services (+0.4%), which represents 80% of UK GDP, drove the bounce back, with wages rising faster than prices a key factor driving domestic spending, despite subdued consumer confidence.

The Bank of England delayed raising rates in May due to the disappointing Q1 figures, but the May GDP figures may suggest that the weak Q1 numbers reflect temporary factors and make an interest rate rise in August more likely.

Brexit is on the horizon and a number of large firms, such as Airbus, raised concerns over access to European supply chains after the UK leaves the EU. At the time of writing, the government has agreed to a united strategy over Brexit that will encourage manufacturers, but the proposal has angered leading Brexiters who fear that only further compromises are likely from here.

The recent Cabinet resignations of Boris Johnson and David Davis create divi-

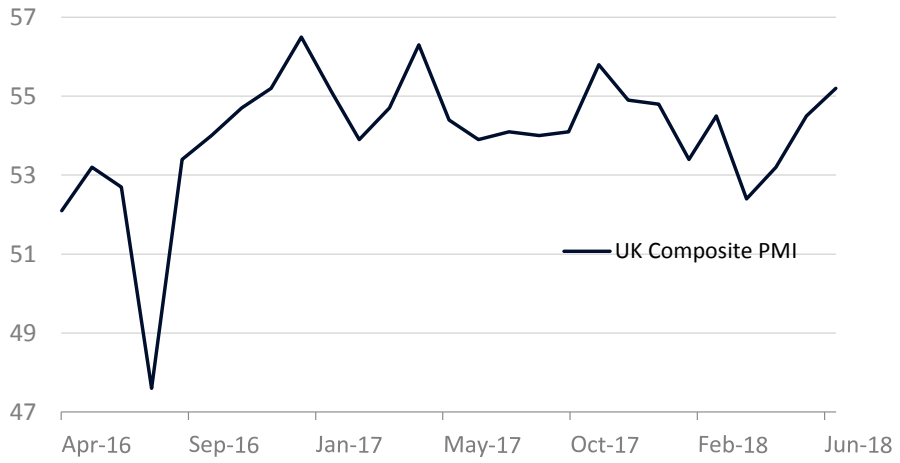
Office for National Statistics

According to the Office of National Statistics, the British economy grew by 0.3% in May alone.

sions that raise the risk of 'no-deal' when as we hit the October deadline.

There has been a robust pick up in UK business sentiment in the last few months, despite growing uncertainty over Brexit.

UK Composite PMIs have risen over Q2 but remain range-bound



Source: Hottinger Investment Management; Bloomberg

Conclusion — keeping an eye on the grey swans

"We remain of the view that in the context of the last decade, global conditions remain favourable, but three tailwinds are solidifying"

We remain of the view that in the context of the last decade, global conditions remain favourable, but three tailwinds are solidifying.

The first is that global debt is rising to levels that the IMF says are greater than they were before the financial crisis. This will create trouble for those banks overly exposed to companies and sectors that have ambitiously taken on too much debt in the anticipation of future revenues.

The second is that monetary conditions are becoming tighter and interest rates are rising, which will expose those firms, governments and households who cannot handle higher borrowing costs; and the banks and investors who provided credit to them.

The third is that global politics is becoming more nationalist and volatile, making events that reduce the ease of doing business more likely. In our feature article, we explore the political situation in Europe in more detail and discuss the threat it poses.

Investment Outlook

Q2 has seen continued volatility with investors becoming less resilient and ever more cautious as global risk rises. Nevertheless, global equities rallied 1.09% over the quarter (as measured by MSCI world) with bonds down 2.78%.

Interestingly, and as Karen Ward, Chief Market Strategist for EMEA at JP Morgan Asset Management, points out the S&P 500 has moved more than 1% in a single day 36 times so far this year compared to only 8 times over 2017. From a relative perspective this is a dramatic change in volatility; however, when comparing it to the long-term norm, this 1%+ move would typically occur approximately 68 times each year. What this suggests is that although investors are facing greater volatility, recent events are a return from a period of abnormality to the norm.

"...although investors are facing greater volatility, recent events are a return from a period of abnormality to the norm."

Both good and bad data have fuelled the seemingly never-ending 9-year bull market as investors sought returns at any cost. Good news reflected a return to health for firms and economies, while bad news would often be met with calming noises from central banks. Now however, the story is very different. With unemployment at historic lows, rising inflation, policy changing from quantitative easing to tapering, trade tensions between the US, China and Europe, markets are no longer as accepting of bad news as they once were.

Growth less synchronised - US, Europe, Japan

Even as global growth is likely to meet forecasts of up to 4% for 2018, performance at the national level is becoming less synchronised. The US is set to push ahead with growth set to reach 3% given a healthy labour market, reasonably modest inflation pressures and robust private consumption; whereas the Euro area and Japan see growth expectations of 2% and 1.5% respectively. This dispersion can already be seen in markets where the S&P 500 is up 2.93% over the quarter compared to the FTSE EuroFirst 300 down 2.73% in common currency USD terms. Trump's expansionary fiscal policy is likely to increase this disparity and its effects will be felt this year and next.

Markets are underestimating China

China's growth engine weakened slightly over the second quarter, owing to deleveraging, credit tightening, trade tensions and consequently rising bond defaults. Following the lowering of reserve requirements for banks by the PBoC, the Renminbi recently reached a six-month low with fears of further weakening to come. Up to this point the Chinese have been cautious about manipulating the Renminbi especially in light of the trade negotiations with the US. However, given the subdued growth outlook President Xi Jinping felt it necessary to stimulate the economy.

Bloomberg

"...markets are no longer as accepting of bad news as they once were."

"...the Renminbi recently reached a six-month low with fears of further weakening to come."

Investors seem to be underestimating the weakness in the Chinese economy as they become fixated on the growth in the US. Markets would not take favourably the unlikely scenario of a currency war on top of the trade war.

A mixed picture emerges for emerging markets

Performance in emerging markets has been harder to predict; robust commodity prices and strong demand from the US should favour continued growth particularly from the exporting economies, yet the impact of higher oil prices and greater dollar funding costs may outweigh these positives and present issues for importing economies. Growth prospects in the region have weakened, from around 6% in Q1 to closer to 5% in Q2. A change in sentiment can be seen in markets too. Data gathered from a quarterly survey of 214 asset allocators show expectations of EM equities outperforming their DM counterpart have fallen and sentiment on the probability of US equities outperforming non-US equities has increased in Q2.

Chinese Renminbi weakens on the back of looser policy and fears of a trade war

Source: Hottinger Investment Management; Bloomberg

"Performance in emerging markets has been harder to predict."

Technology is still the dominant sector in the United States

Unsurprisingly, the Technology sector continued its dominant run leading the S&P 500. A large portion of the S&P 500 return can be attributed to the FANG+ Index (FAANGs combined with additional consumer-facing technology companies such as Twitter, Tesla, Alibaba and more), which over the quarter rallied 17.67%. The FAANG stocks alone now represent more than 11% of the capitalization-weighted S&P 500 with the tech sector as a whole representing more than a quarter. All-in-all investors' on-going conviction and optimism that Technology will outperform other sectors remain, despite their high valuations.

Following the tariff tantrum, US Industrials and Financials were notably seen as two sectors that were oversold as investors priced in their expectations; both have realised a positive recovery that reinforces investors' continued belief in markets and the US economy in particular where buying the dips as an investment strategy generates positive alpha. The move in financials was further aided by a steepening of the yield curve.

"The FAANG stocks along now represent more than 11% of the capitalization-weighted S&P 500."

In terms of valuation, Technology and Consumer Discretionary stocks appear overvalued relative to historical averages whereas Telecoms and Real Estate appear undervalued, particularly when looking at dividend yields and earning potentials.

Still waiting for the great rotation away from growth stocks

The disparity between value stocks and growth stocks is approaching the peak similar to that seen in the Internet bubble of the late 1990s. Value stocks remain oversold and a rotation out of over-valued growth stocks, as was expected after the February sell-off, remains to be seen. This behaviour typically resembles the later stages of a bull market where investors flock to superior stocks that appear more resilient to market headwinds as well as competitive pressures.

Heightened credit risks show up in an elevated LIBOR-OIS Spread

Source: Hottinger Investment Management; Bloomberg

"The disparity between value stocks and growth stocks is approaching the peak similar to that seen in the Internet bubble of the late 1990s."

Rising credit risks as yield curves continue to flatten

Libor-IOS spreads, a useful indicator as to the credit risks present in the banking sector, recently neared its nine-year high. Prior to the subprime mortgage crisis in 2007 the Libor-IOS spread was as little as 0.01% yet at the peak of the recession it grew to 3.65%. In March, this gap reached just below 0.60% having averaged around 0.20% since 2009 and currently sits at 0.37%. In addition the US yield curve is slowly flattening as the difference between the two year and 10 year treasuries dropped below 0.30% (current 2-year yields are 2.57% com-

"This combination of wider credit spreads with a flattening yield curve indicates some degree of stress in the markets."

pared to the 10 year yield of 2.87%). This combination of strained credit spreads with a flattening yield curve indicates some degree of stress in the markets as investors buy longer dated bonds in search of safer investments.

UK bonds show a similar story. 2-year UK gilts stand at 0.74% compared to the 10-year at 1.30%, representing a larger spread compared to its US counterpart of 56 basis points but again one that has reduced.

In Europe, Italian bonds are noticeable and will continue to be volatile given the sensitivity of ongoing political instability.

Gold is a valuable diversifier

The combination of a rising dollar and higher US interest rates (3 month treasury 1.95%) has had a profound effect on the depreciation of gold throughout 2018. As of writing, gold has dropped 3.73% year to date and - 5.82% over Q2, recently reaching its lowest level in more than 6 months. Despite the volatility in stock markets, trade tensions and other political instability, the asset has failed to pick up traction amongst investors. Until such a time when systemic risk appears material, holding gold is valuable as a diversifier.

The strengthening dollar is the dominant trend

In term of currencies the dollar continues to appreciate given a strong economic outlook and quantitative tightening. The sterling peaked at GBP/USD 1.42 on the 16th of April yet has since depreciated currently sitting at GBP/USD 1.32 following on-going Brexit-related noise. The euro has remained fairly steady against sterling, hovering around EUR/GBP 0.88 but the outlook remains uncertain given political instability particularly in Italy.

Conclusion

"Although the consensus is for the world to be heading towards the end of a bull run a recession does not seem apparent in the near term."

Overall Q2 could be argued as a continuation of a market transition period back to normal following years of favourable policy and low volatility. Although the consensus is for the world to be heading towards the end of a bull run, a recession does not seem apparent in the near term but more likely in 2020 or 2021. This is further emphasised by forward P/E multiples where only the US appears to be slightly overvalued while Japanese equities are trading at the largest discount.

Finally, it is worth noting that current tariff proposals amount to less than 4% of total US imports. The tariffs have undoubtedly caused a sell off in equity markets; however, unless team Trump ramp up further tariffs it is unlikely to materialise into a systemic risk.

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