October 2018
Issue No. 9

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

GLOBAL INSIGHT

Overview

- In early October, the IPCC issued a new report stating that meeting the 1.5°C warming target requires global CO2 emissions to fall to zero by 2050 and for renewable technologies to provide at least 85% of global electricity.
- In our **feature article,** we review how financial services can provide the solution to climate change.
- In our **Macro View**, we assess the effects of a slowing in growth momentum that is playing out across the three main global regions: The United States, China and the European Union.
- Trade growth has fallen throughout 2018, from a quarterly rate of 1.0% at the beginning of the year to 0.4% in Q3, according to the OECD.
- As capital expenditure disappoints and temporary factors fade, the US moved into slower lane in Q3. A drop in export demand from China and rising oil prices have hit European production, and a strong dollar has created a more challenging environment for emerging markets.
- In our **Investment Outlook**, we discuss whether the strong performance in equities over Q3 is over-extended, with risks from trade tensions, fading tax cuts, tighter monetary policy and higher bond yields.
- Although we saw strong gains in equities in the US and Japan, there were also nascent signs of a rotation from cyclical to value sectors.
- At the present time, we prefer equities but with a tilt to the more defensive sectors and long-short funds. While we are cautious on corporate bonds, short-dated, inflation-protected government bonds are becoming attractive.

Can US inflation push much higher and what does this mean for interest rates?

Inside this issue

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Economic Highlights

- US Core PCE inflation broke 2.0% target in July.
- The Federal Reserve expects interest rates to rise to 3.1% by end-2019.
- UK grew by 0.7% in the three months to August.
- Oil prices increased by 7% during Q3.

Contact Details

Hottinger Investment Management Limited

27 Queen Anne's Gate
London SW1H 9BU

+44 (0) 20 7227 3400

info@hottinger.co.uk

www.hottinger.co.uk

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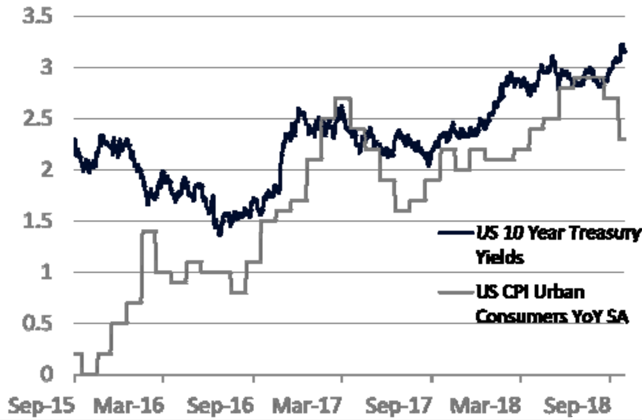
Based upon information available up to and including 15th October 2018

Key Issues in Charts

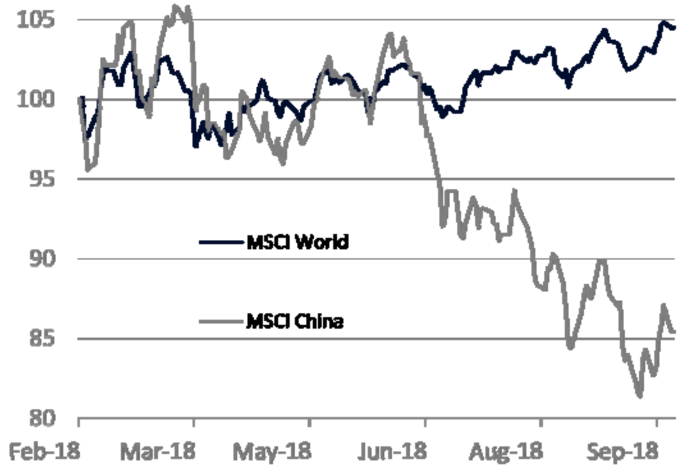
Range-bound US inflation could arrest the rise in yields



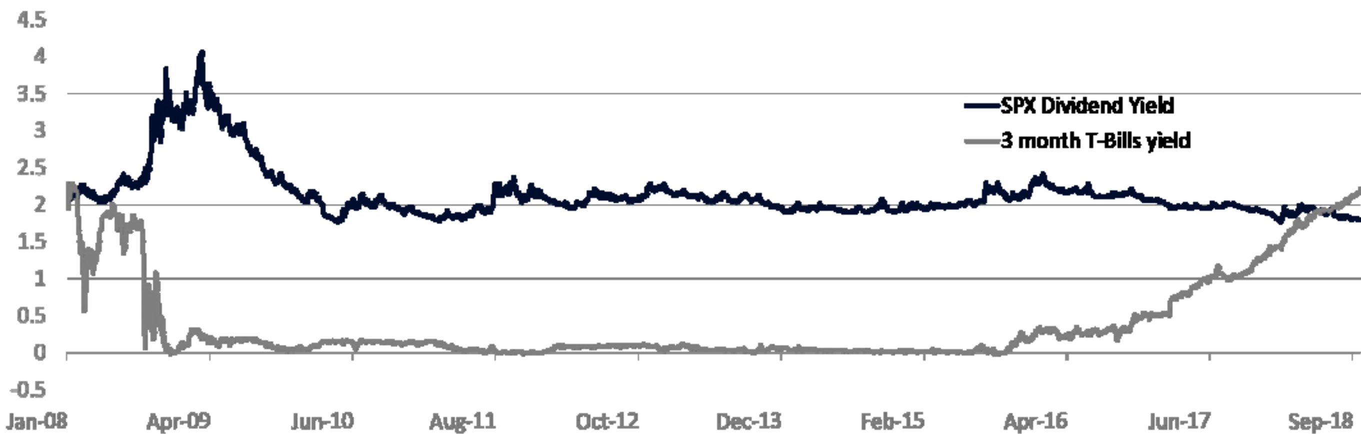
- The rise in 10 year yields through 2018 appeared to be moving in line with CPI inflation, but the latter measure has receded somewhat during Q3.
- This suggests that real 10-year interest rates are rising, a sign that the US economy is moving into a mature phase in the cycle.
- However, the so-called 'neutral real rate of interest' remains low, so further rises in bond yields will require either inflation to move higher again or for the neutral rate to itself to rise as a result of faster growth in productivity, hitherto elusive.

Chinese equities diverge from the global trend

- While China's official economic growth has remained stable throughout 2018 and close to the government target of 6.5%, mainland stocks have had a more troubling time.
- The clampdown on credit has hit trading volumes and house price growth, a major driver of recent consumer spending.
- In addition, with potentially all exports to the United States facing tariffs, the rise in uncertainty has reduced confidence.



Short-dated government debt T-Bills are giving US equities a run for their money



- During Q3 it became possible to earn more on a rolling cash basis from 3-month US Treasury Bills than it was through dividends from stocks on the S&P 500. The figures are not like-for-like as the dividend yield is protected from inflation, while T-Bills are exposed to a few months of rising prices.
- In the last few years, investors have been pricing in rising earnings and will expect to see higher dividends in future yields to justify valuations, but if interest rates continue to rise equities will start to come under severe pressure as funding costs increase and bonds become more attractive.

Developing green bond markets can help investors to fight climate change

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

We all know we are running out of time to address climate change. Based on existing climate policies and forecasts of future emissions by the Intergovernmental Panel on Climate Change (IPCC), we have less than a 5% chance of keeping global temperature rises below 1.5°C – levels at which the consequences remain manageable. It is now considered more likely than not that warming will exceed 3°C, leading to a big uptick in extreme weather events.

In early October, the IPCC issued a new report that to meet the 1.5°C target, global CO_2 emissions need to fall to zero by 2050 and by then renewable technologies need to provide at least 85% of global electricity.

"Expected losses to investment portfolios due to climate change in today's money lie between $4.2 trillion and $13.9 trillion."

Our economic system is clearly currently unsustainable. The financial services industry however holds an influential position. With outstanding equities and bonds standing at $160 trillion, it oversees and underwrites the global economy. If we manage to avoid the worst effects of global warming, it will be because financiers fund the transition to the low-carbon economy.

And there is a good reason why we should; climate change is bad for business. According to the Economist Intelligence Unit, the expected losses to investment portfolios due to climate change in today's money lie between $4.2 trillion and $13.9 trillion, as hostile conditions harm firms' operations, sales and supply chains. Losses in a 4-6°C warmer world would be much greater and these estimates are conservative and disregard social and political costs.

Changing course, however, remains very possible. Forecasts from the International Energy Agency suggest that up to $120 trillion in global infrastructure investments will be made before 2050, with most activity in emerging economies. Aligning these investments with a low-carbon future increases this figure by $44 trillion, but once such infrastructure is in place, radically lower fuel costs generate long-term real savings of $74 trillion. In finance jargon, the green economy provides positive net present value.

"Funding the green transition should not be seen as a cost or a burden to investors who take a long-term view."

Funding the green transition should not be seen as a cost or a burden to investors who take a long-term view. But it requires a willingness to sacrifice immediate results from all concerned–including businesses, governments and investors. To this extent, it is not surprising that younger investors and millennials, who have long time horizons, have fuelled the surge in interest in sustainable finance.

As it stands, however, good short-term returns are still available from the business-as-usual economy while there are not enough green investment opportunities into which investors can redirect their capital. Using public policy to turbocharge the debt financing of infrastructure investments through, particularly through so-called 'green bonds', provides an ideal solution.

"The OECD estimates that about 60% of the climate finance needed in the US, EU, China and Japan through to 2035 will be debt-based."

Building markets in green bonds

The OECD estimates that about 60% of the climate finance needed in the US, EU, China and Japan through to 2035 will be debt-based. The growing market in green bonds is tapping the $100 trillion bond market and supporting green bank lending. Last year, $155 billion in labelled green bonds were issued, up over 80% on 2016. The sector could reach $1 trillion in new issuances per year by the early 2020s, but it will need support from a wide array of stakeholders.

Green bonds are like ordinary bonds but come with a specific and verified mandate for funds to be used for sustainable activities. Since the mid-2000s, development banks, sovereign states and corporates have issued green bonds; high profile issuers include Danish energy company Ørsted, Apple and the New York Metro. Commercial banks can also provide access to green projects indirectly by securitising their sustainable infrastructure loans and passing them onto asset owners.

The green bonds fund renewable energy, low-carbon transport, energy-efficient buildings and sustainable water: projects that involve the installation of proven technologies with high up-front costs, but long, stable cash flows. They may be an attractive fit for pension funds and insurers, which have long-term liabilities.

Long-term infrastructure projects such as these are typically very sensitive to the cost of financing. Policies that bring down these costs would increase the attractiveness of starting low-carbon projects and increase their supply onto the market.

One option is to increase public bond issuance. The European Investment Bank and the China Development Bank are big issuers of green bonds, as are the state of California and the Republic of France. Funds raised by public issuers at low rates can be used to fund public works, provide subsided finance to green companies or fund credit enhancements for pools of riskier projects. These last two uses, structured correctly, could attract equity capital, while the first is essentially labelled sovereign debt.

"Requiring that public sector funds own sovereign and corporate green bonds would resemble features of the world's first bond market, in 13th century Venice."

Governments could also work with public-sector pension funds to direct their capital into the green bond market, pushing down the cost of capital. Requiring that public sector funds own sovereign and corporate green bonds would resemble features of the world's first bond market, in 13th century Venice. Prestiti were mandatory long-term loans from citizens to the Venetian state to fund wars against the Byzantine Empire. In 1261 under the Ligato Pecuniae, Venice placed all its debts into a permanent fund paying 5% interest and allowed citizens to trade it on secondary markets. The move not only democratised finance, by broadening the creditor base, but aligned it with the goals of the state.

Modern central banks with revised mandates could play a vital role along similar lines in the development of the green bond market. Their ability to buy and hold sovereign and commercial bonds can affect the level of investment in the economy.

However, if central bankers' policies are to have maximum effect, we need to learn from the post-crisis experience. According to the Deutsche Bundesbank, external financing into the euro area's real economy since 2015 has been flat, despite €2.3 trillion in asset purchases (QE) by the ECB. The link between QE as has been practiced and real investment appears to be rather tenuous.

"Policy solutions can build liquidity and private sector confidence in the green bond market, while offering sources of low-cost, long-term patient capital."

For a green QE to be a success, it should be coupled with new issuances of green bonds by governments and development banks that have earmarked specific green investments. Not all new public debt, of course, can be earmarked for green investment, and not all QE should be green. But given the financial stability risks posed by high-carbon investments, there is a good case for a sizeable portion of central banks' asset purchases to be in green bonds.

Regulators can also use macroprudential policies to discourage bank lending into unsustainable industries by raising the capital requirements of banks that excessively do so. They could also look at ways to incentivise green loans and securitisation, allowing banks to recycle their capital, without compromising financial stability and credit quality.

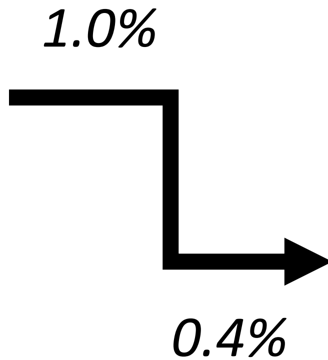
Together, these policy solutions can build liquidity and private sector confidence in the green bond market, while offering sources of low-cost, long-term patient capital. Together, they would help the financial services industry underwrite the transition to the sustainable economy.

"A financial services industry that has plentiful projects into which to redirect its capital will take up the challenge."

Time for action

While we are currently falling behind in our efforts to beat climate change, it is still within our power to avoid the worst. A financial services industry that has plentiful projects into which to redirect its capital will take up the challenge. Policymakers, however, need to play their role too, creating the conditions under which the green transition can happen.

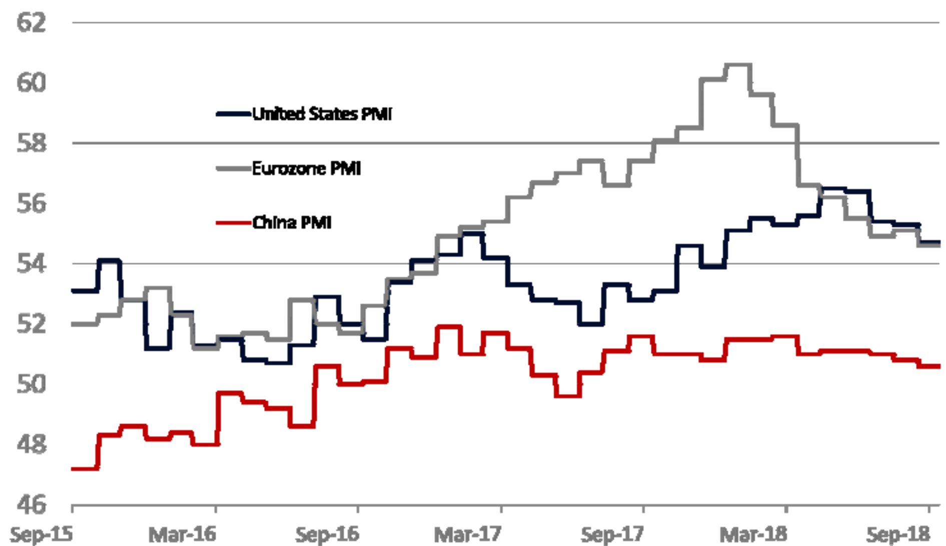
Macro View



The summer quarter was the first in which we saw a sustained softening in the momentum behind global activity. Surveys of manufacturing companies in each of the world's major regions – the US, Europe and China – found that business confidence and orders were softer in the third quarter of 2018. Tighter financial conditions as central banks continue to tighten monetary policy are biting, while the strong US dollar, rising trade restrictions and higher rates have hit emerging markets. As a result, global trade growth has fallen throughout 2018, from a quarterly rate of 1.0% at the beginning of the year to 0.4% in Q3, according to the OECD.

"Global trade growth has fallen throughout 2018, from a quarterly rate of 1.0% at the beginning of the year to 0.4% in Q3."

Global manufacturing activity loses momentum



United States

"Economic expansion in the United States is now into the 112th month and is the longest the country has seen since WWII..."

Economic expansion in the United States is now into the 112th month and is the longest the country has seen since WWII and only eight months younger than the longest expansion in history. But while it has been long, it has been a mostly underwhelming expansion with the exception of a few strong quarters such as the last one. There are indications, however, that the country is already moving back into a slower lane. While some features of an economy at the mature part of its cycle – such as very low official unemployment and strong growth – are there, others are not. In September, US wage incomes grew at a rate (2.9%) that barely beat headline inflation (2.7%).

While the boost from the larger US fiscal deficit this year continues to provide a headwind to growth, few economists think that the impressive annualised Q2 growth figure of 4.1% (driven by cuts to income taxes and a rush of soybean exports to beat tariffs) can be sustained. While the overall expansion of the economy this year looks likely to exceed the 3% average for US growth rate

since 1950, the recent slowdown in momentum suggests a reversion to its post -2007 crisis trend growth rate of around 2%.

This view is underlined by the disappointing levels of business investment, despite initially hopeful expectations. Capital expenditure (CapEx)– which typically rises when there are inflationary pressures in labour markets and has the effect of lifting productivity, cutting unit labour costs and sustainably raising earnings – has increased at slower rate than it did in the period between 2010 and 2012 and well below that 8-10% annual rate seen during most of the 1990s, despite big tax incentives from the US government. Notwithstanding the pick up in operating profits among large firms in Q3, the weaker ability for workers to push for higher wages and the consequently restrained pre-tax growth in consumer incomes have led to the absence of serious inflationary pressures and discouraged companies from investing.

"During this recovery, we have seen one of the slowest rate-hiking cycles from the Federal Reserve."

However, if unemployment trends even lower, perhaps as a result of the continued fiscal stimulus, at some point workers will start to demand higher wages that feed into overall inflation and encourage more CapEx spending. This might lie behind the slightly more hawkish stance implied by the latest release of interest rate expectations (or 'dot-plot') from the Federal Reserve. Most FOMC members think policy is still accommodative and that Core PCE inflation will therefore continue to rise beyond its 2% target, where it sits today.

During this recovery, we have seen one of the slowest rate-hiking cycles from the Federal Reserve. This most likely reflects both the uncertainty over the real strength of the US economy – as the bargaining power of workers falls in the wake of rising job automation and the willingness for people to accept jobs that have insecure tenure and conditions – and concern about 'overshooting'. The so-called neutral rate of interest, the level that neither stimulates nor contracts the economy, has steadily fallen over the last 30 years – reflecting the slower pace of innovation and the falling rate of profit from older discoveries. This means that the Federal Reserve needs fewer rate hikes to successfully tighten business activity.

However, the Federal Open Markets Committee, which sets US interest rates, believes that the most likely level for the interest rate in the next twelve months is 3.1%. This implies that the body will raise rates by 25 basis points each quarter into late 2019. The 60-basis point difference in 1 year forward OIS and the spot OIS that held steady for most of Q3 implies that the market expects just two or three 25-basis point rises next year and that it believes the neutral rate of interest is lower than the Fed thinks. The risk that the Fed runs by raising rates further than the market expects is not just for risk assets – encouraging defensive moves from growth stocks to value stocks; and from stocks generally to bonds – but for the wider economy as a whole. We stress again that central bank overshooting, often initiated by the United States, is

The Federal Open Markets Committee believes that the most likely level for the interest rate in the next twelve months is 3.1%.

the most likely cause of recessions. For this recovery, with the big increases in corporate leverage in recent years, there is more refinancing risk for companies exposed to rate rises than usual.

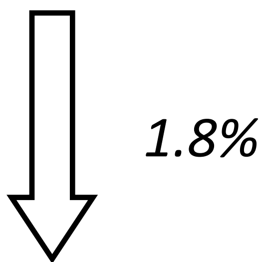
Europe

Europe has experienced the most precipitous fall in its growth momentum this year. To a large extent this was not surprising. French, German and Spanish manufacturing companies built up huge inventories, partly on the back of a pick-up in domestic demand and consumer confidence, but mostly due to strong export demand growth of over 5% from the US, China and India over 2017. However, the EU is also a major energy and resources importer and it increased its total imports from Russia by over 10% between the first half of 2017 and the first half of 2018, reflecting both the greater requirements of industry and the 50% rise in the price of oil since August 2017.

The concern for Europe is that the impressive surge in growth it enjoyed in 2017 was dependent on a rise in global trade.

The concern for Europe is that the impressive surge in growth it enjoyed in 2017 was dependent not only on a rise in global trade, but also support from the European Central Bank. This is likely to end next year as bond buying finishes, contingent loans (TLTROs) to commercial banks start to mature and the Governing Council looks to start raising interest rates. Yet at the same time, levels of investment in many EU member states remain well below their pre-crisis averages, suggesting that withdrawal of ECB stimulus might be premature. For the EU as a whole, the ratio of investment spending to total GDP between 2007 and 2017 dropped by 3 percentage points, with bigger falls in Italy (-4pp), Spain (-10pp) and Greece (-13pp).

Core inflation in Europe, however, remained stubbornly low throughout Q3 at around 1.0%, well below the ECB's target; so while the Governing Council believes that core inflation will accelerate over the next twelve months, it has wisely maintained discretion to pause its planned programme of policy tightening should that fail to happen. In any case, we think that the performance of the European economy is more dependent on policy support than the United States because it is in an earlier stage of its recovery and has relied too much on exports to support employment and inflation rather than investment and domestic demand. In early October, the German Finance Ministry, for example, downgraded its expectations for 2018 growth from 2.3% to 1.8% (and from 2.1% to 1.8% in 2019) – barely more than is forecast for the UK – citing concerns over weak trade volumes.



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It is in this sense that the situation in Italy has broader relevance. The European Commission and many Northern European states, at the time of writing, are trying to block an expansionist budget from the new populist Italian government which amounts to a structural deficit of over 2% of GDP. The budget Eurozone rules limiting structural deficits to 0.5% of GDP for countries with high debt burdens such as Italy, but the government has the support of over 60% of

Italians who see greater public spending as the route to a stronger economy after years of belt tightening. With the ECB pushing for tighter monetary policy and with ambitious fiscal policy off the cards, it is hard to see how Europe can close its investment gap and maintain its momentum into the medium term.

China & Emerging Markets

Activity in China has also softened over the quarter as the People's Bank of China (PBoC) continues to reverse its previous measures to restrict lending by banks and non-banks and encourage deleveraging across the economy. The step down in global trade growth has centred on China. Data on Asian freight transportation and Chinese inventories point to this, as does the lock-step declines in the year-on-year growth of export and import volumes during the quarter (in exports, from 12.2% in September 2017 to 9.8% in September 2018; and in imports, from 27.3% to 20%). Volume growth is still very high and reflects China's status as the workshop of the world, but the slowdown nevertheless matters. No doubt a part of this softening has to do with the effect of US import tariffs and its threat of more, but the root cause is the global fall in the growth in money supply and bank lending. It's the manufacturing sector that feels these effects most and nowhere is that more acute than in China.

It's the manufacturing sector that feels the effect of weaker bank lending, and nowhere else is this more acute than in China.

The PBoC has cut the reserve ratio requirement, the proportion of bank liabilities that must be held in reserve, four times this year, from 17% to 13.5% in October. Such moves, by releasing liquidity, allow banks to increase lending collectively by hundreds of billions of dollars. If industrial activity continues to disappoint, the PBoC and the central government have other tools at their disposal, whether it be cutting interest rates, boosting its medium-term lending facility – which incentivises banks to lend to small and medium sized companies – or fiscal investment activity that raises the overall level of demand.

Emerging markets were hit over the quarter by increased dollar scarcity as US rates rose and the dollar strengthened. Emerging market indices, measured by the MSCI EM index, have fallen back by about a third over 2018, decisively ending a two year rally that started at the beginning of 2016. With much talk of an emerging market debt crisis in Argentina and Turkey, we should be careful not to generalise these two cases. What the two countries have in common is that they both have large budget deficits, large current account surpluses and a high and rising level of external debt.

With much talk of an emerging market debt crisis in Argentina and Turkey, we should be careful not to generalise these two cases.

This is not typical for Emerging Markets as a whole; countries such as South Korea, Russia, India, China and Thailand have falling external debt balances and – in most cases – current account surpluses. It would be too simplistic to call a general crisis in emerging market debt, as the issues that the sector is facing largely revolve around falling trade volumes emanating out of China and – to a lesser extent – the effect of the stronger dollar on commodities demand.

United Kingdom

Growth for the year is unlikely to exceed the 1.8% growth the UK produced in 2017.

In the UK, growth has been steadily rising. In the three months from June to August, the economy grew by an estimated 0.7% (annualised to about 2.9%), but there are strong caveats. One is that the figures include big contributions from construction recovering from the poor weather at the start of the year. Another is that the summer heatwave gave a one-off boost to the retail sector. In August, according to the ONS, growth in services and industrial production was flat while and the construction sector shrank. We think therefore that official Q3 growth, which includes September's figures, is likely to come in a bit lower than 0.7%, with figures for Q4 lower still, meaning growth for the year is unlikely to exceed the 1.8% growth the country produced in 2017.

Markets expect the Bank of England to raise rates twice in the next twelve months, but this may reflect uncertainty over the outcome of Brexit rather than the underlying condition of the UK economy. While growth remains relatively weak, labour markets are tight with unemployment at 40 year lows, real wages are rising, and inflation remains stubbornly above 2%.

At the end of the quarter, hopes of a disruption-free Brexit deal receded as the European Union pushed back on Theresa May's Chequers plans that maintain access for British manufacturers to the EU's single market, and essentially told the Prime Minister that the choice was either a distant Canada-style trade agreement or a deeply integrated Norway-type deal which offers few benefits over full EU membership. Neither option would command a majority in the House of Commons, so the hope going into Q4 is that the UK and EU sides can agree suitable compromises around the Chequers plan sufficient to command the support of 322 Conservative and Labour MPs (as well as any of those of other parties). The start of Q4 therefore saw deep uncertainty with multiple outcomes foreseeable, including a second referendum or a new election.

Conclusion

As the finishing line for negotiating Brexit appears, will enough British MPs support any deal?

The global economy remains in good health but it has lost some momentum over the last three months, largely driven by the changing policy stance of global central banks. While the unwinding of unprecedented amounts of monetary support continues to be a leap into the unknown, policymakers have the flexibility to adjust its pace and depth. We hope they use that discretion carefully and remain thoroughly empirical in their outlook.

Many of the certainties of macroeconomic theory have broken down over the last ten years, not least the hitherto robust relationship between inflation and unemployment, suggesting that Banks might need to keep rates lower for longer. Yet at the same time, as a consequence of easy monetary conditions, dollar-denominated debt and leverage continue to build up in pockets of the world economy, in some places to dangerous levels. Policymakers therefore have an unenviable task of walking a tightrope, but it is essential that they keep their balance as fair-weather conditions fade.

Investment Outlook

US outperformance was the dominant theme in financial markets during Q3, accompanied by US dollar strength and a back-up in US rates that contributed to a crisis in several emerging markets.

AMERICA FIRST

“US outperformance was the dominant theme in financial markets during Q3…”

The Federal Reserve (Fed) reacted to strong economic growth and buoyant consumer spending by delivering its eighth interest rate increase in the current tightening cycle, the third this year. By the end of the quarter, the 10-year US Treasury yield had risen through 3% for the second time is 2018. Further along the risk scale, high yield outperformed high grade corporate credit and the S&P500 Index extended its lead over other regions, gaining 9% year-to-date. The much publicised trade tensions do not seem to have impacted corporate earnings, as yet, while Trump’s tax reforms have boosted bottom lines. It is probable that Chair Jay Powell will continue to raise US policy rates to offset the expansionary fiscal stance following his recent Jackson Hole speech.

However, according to Absolute Strategy Research, there are signs that the economy may be about to slow as tighter monetary policy has resulted in a sharp slowdown in the pace of narrow money growth. If this is the case, then at current levels the US 10-year Treasury starts to look attractive. Even on US dollar cash, investors are able to earn 2.2% which exceeds the dividend yield of the S&P 500.

2 year Treasuries paying close to 3% are tempting equity investors

There is little inflation priced into the inflation-linked bond markets at present. Inflation has remained subdued in this business cycle but has started to move higher, albeit modestly. Whilst it appears unlikely that prices are about to take -off, bond yields and returns are so low that in real terms they should be sensitive to even a modest increase in inflation. In the current environment where

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oil prices have risen by 50% in the space of a year, the US has engineered a huge fiscal boost and the European Central Bank (ECB) has stated that fiscal strings are being loosened (albeit modestly), international inflation-linked bonds have a place in selected portfolios. The asset class, having a negative correlation to equities and high yield bonds, can also serve to diversify risk.

In Europe, rates and investment returns on fixed income should remain low for some time.

The Eurozone economies have lagged the US but the broad picture is still one of economic expansion and low inflation. The ECB is somewhat behind the Fed in exiting unconventional policy having had to fend-off deflationary pressures. As a result, rates and investment returns should remain low for some time. German bund yields are pretty much unchanged this year despite some volatility in the early part of the year when it looked as though the economy was moving up a gear. By contrast, Italian bond yields ended the quarter at a five-year high of 3.25% after Rome unveiled plans for a sharp increase in public spending, risking a collision with the EU.

UK yields shifted higher across the curve during Q3 as economic activity surprised to the upside. In July, movements in the yield curve provided a glimpse to how Gilts might react in the event of a hard or disorderly Brexit. The 2-year / 10-year curve flattened to 46bp following the resignations of foreign secretary Boris Johnson and minister for Brexit David Davis in response to Theresa May's Chequers deal. This gap was the lowest since the financial crisis, barring a brief period following the 2016 referendum. It served to highlight the concerns about future economic activity outside of the EU. We remain underweight gilts ahead of the critical March 2019 Brexit deadline date. We believe rates will move higher next year irrespective of whether an agreement is reached. In the event of an orderly Brexit we would expect growth and inflation to continue at current levels, thereby justifying further tightening. Under a 'no-deal' scenario, growth would likely fall whilst inflation would rise as a result of a weaker exchange rate and the introduction of WTO tariffs. Initially the Bank of England might ease policy to support the economy but ultimately would need to hike rates at a faster pace to combat rising prices once the economy stabilised.

The share of lower grade (BBB-rated) bonds in the investment grade indices has risen to almost 50%.

Emerging market bonds remained under pressure in those countries with large current account deficits and high levels of dollar-denominated debt. The market as a whole has sold off to the point where the EM bond index now yields around 6.5%. This level has marked the cyclical high for yields on several previous occasions since the 2008 crisis. However, caution is warranted while dollar strength persists.

We also remain cautious on corporate bonds where yields have risen above 4% for the first time since 2010-2011. The reasons being are that the share of lower grade (BBB-rated) bonds in the investment grade indices has risen to almost 50% from 35% in 2006 and the leverage in the US investment-grade index has risen from 1.4 times to 2.5 times during the same period. In spite of this, spreads above government bonds are close to their lowest levels.

Equity markets regained their poise in Q3, led by strong gains in the US and Japan. Meanwhile, the eurozone region eked out a positive gain while the UK and emerging markets lost ground. There were also nascent signs of a rotation from cyclical to value sectors.

Four major factors have fuelled the recent rally in US equities: healthy economic growth, positive earnings, share buybacks and President Trump's tax reforms. Almost four-fifths of S&P500 companies beat earnings in Q2, the highest since FactSet began measuring the data a decade ago. Earnings rose by almost 25% year-on-year whilst margins reached a record 11.8%. That said, some high-profile tech names disappointed including Intel, Netflix and Facebook. Nevertheless, the earnings windfall combined with the tax efficient repatriation of profits previously held overseas helped finance the rise in buybacks. According to Zion Research Group, lower tax rates accounted for almost half of the year-on-year earnings growth of S&P 500 companies.

In equities, there were nascent signs of a rotation from cyclical to value sectors.

The key question going into the final quarter is whether the outperformance of US equities is over-extended. There are several risks. Firstly, there is scope for trade tensions to escalate. Chinese government officials have already threatened to implement non-tariff "qualitative" measures which could impact the activities of US companies in China. In addition, whilst US trade talks with NAFTA have been resolved, there are still wide gaps in the negotiations with the EU. Second, the boost from the tax cuts is set to be temporary. Thirdly, the actions of the Federal Reserve could start to weigh on the US equity market if it continues to raise rates whilst stepping-up the pace with which it tightens its balance sheet. Last but not least, with three-month Treasury bills yielding more than the S&P 500 index for the first time in a decade, effectively a safe, liquid asset class has become available to investors. On balance, much of the US earnings boom is probably priced-in but US stocks should find support from positive earnings momentum and the favourable fiscal environment. Further out, we would look out for signs of earnings tailing off as the fiscal stimulus subsides and the business cycle matures.

"The key question going into the final quarter is whether the outperformance of US equities is over-extended. There are several risks."

Since the Brexit referendum, the UK equity market has been a perennial underweight for many international investors that have concentrated on the potentially negative connotations for the domestic economy and currency. Historically, periods of sterling weakness have been positive for the UK equity market. In recent months however, the FTSE 100 index has underperformed in both local currency and US dollar terms. Part of the reason could be the rise in speculation that a General Election could be called in the event of a 'no deal' scenario. There is growing disunity within the Tory party whilst, for its part, the opposition Labour Party has promoted a more pragmatic approach on Brexit and is finding a receptive audience. It has also managed to capture the mood of the times including a pledge to shift the balance of power back towards workers, including those in the gig economy.

Yet, the prospect of a left-wing Corbyn / McDonnell government creates un-

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The UK's relative valuation is approaching a 30-year low versus the MSCI World Index, representing a premium on other major markets.

certainty for businesses and investors alike with its economic policies including plans to potentially raise corporation tax, nationalise the utility companies and invoke a "Robin Hood" tax on financial transactions in the City. Politics to one side, the UK market is trading at a discount. Morgan Stanley research shows the UK's relative valuation is approaching a 30-year low versus the MSCI World Index whilst the dividend yield is around 4%, representing a premium on other major markets. The relatively defensive nature of the UK index should stand it in good stead in a late-cycle environment.

European equities posted a mildly positive return on the quarter, but remain negative for the year and unloved compared to their US peers, even as economic activity has held-up and corporate earnings have continued to improve. As a result, valuations are not demanding and the weaker currency should assist the region's exporters going forward. The same can be said for Japanese equities. While both of these markets are more exposed to the uncertainty from trade tensions and stresses in emerging markets than the US, their discount in terms of relative valuation has widened to compensate for the risk. In the case of Japan, corporates are actively taking measures to boost efficiencies including devoting more capital expenditure to automation and robotics, which should ultimately improve both growth and equity returns.

Emerging markets historically have had a strong inverse correlation to the US dollar, thereby partly accounting for the poor performance so far in 2018. The optimism from the start of the year has dissipated and valuations appear undemanding, trading on a forward P/E of 11.5x, which represents a 27% discount to developed markets. Clearly, there are risks including trade tensions and the high levels of debt in certain countries. But there are reasons to believe that some kind of stability could return as US dollars short positions have been unwound and much of the bad news has been discounted in valuations.

In summary, after ten years of rising stock markets and falling bond yields it is tempting to believe that these benign conditions can continue into the foreseeable future. However, tighter global liquidity poses a risk as highly accommodative monetary conditions shift to central bank balance sheet contraction. Historically, increased market volatility has accompanied tighter monetary conditions while yield curve flattening has tended to be a strong signal that the equity market is close to a peak. For US investors, short-term rates above 2% and 10-year Treasury yields above 3% offer some portfolio protection. For sterling investors, two-year gilt yields of less than 1% are not so attractive, but we believe that yields could rise post-Brexit.

At the present time, we prefer equities but with a tilt to the more defensive sectors and strategies.

At the present time, we prefer equities but with a tilt to the more defensive sectors. US equities should continue to outperform into the final quarter driven by positive earnings momentum and continued fiscal stimulus. In addition, US stocks tend to be more robust when market conditions take a turn for the worse. We have also selectively introduced long / short equity funds to portfolios through the course of this year. This strategy has meant sacrificing some upside in the event the bull market continues but should dampen volatility and provide some protection for portfolios should markets turn.

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