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HOTTINGER

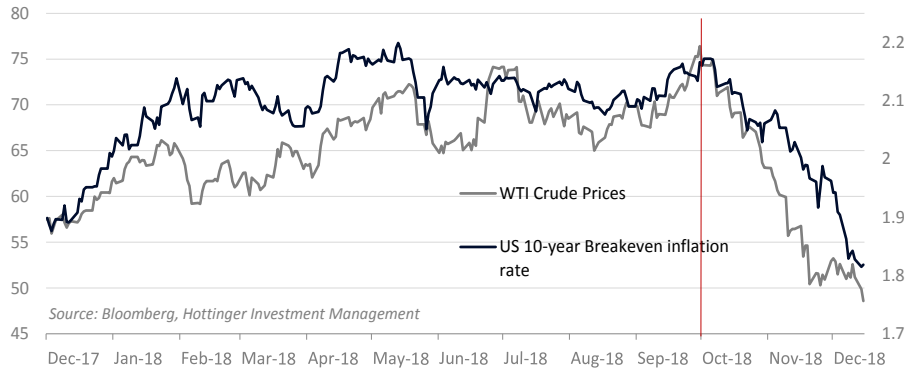
GROUP

GLOBAL INSIGHT

Overview

- Innovation is nothing new for Hottinger - the family name is steeped in history and its members have been a prominent and pioneering force in the world of financial services since 1786.
- This year we continue that legacy. In our **feature article,** we introduce Hottinger Investment Circle, a new concept for clients to exclusively access high-quality, off-market opportunities and make mutually beneficial partnerships.
- In our **Macro View**, we posit that the global economy lost further momentum over the last quarter of 2018 but that it still looks reasonably strong going into this year.
- The prospect of continued fiscal stimulus in the US, moderate public spending in France and Italy, and tax cuts in China could offset the more restrictive monetary and credit policies of central banks.
- However, risks to the downside broadly remain. The Federal Reserve could overshoot, the cold US-China trade war could turn hot, and political difficulties in Europe could interact dangerously with a weakening economic outlook.
- In our **Investment Outlook**, we review the markets in 2018, which was a year of negative returns in most asset classes as monetary policy becomes less accommodating.
- Investors should position themselves for lower earnings growth prospects in 2019 with a more cautious asset allocation that favours short-dated bonds over risk assets.

Oil prices fell by around 40% in Q4, pushing down U.S. inflation expectations.



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Economic Highlights

- The global economy likely exceed 3.5% growth during 2018.
- The Federal Reserve revised down the number of interest rate increases in 2019.
- Wages in the Eurozone grew above inflation in Q3.
- Oil prices fell by almost 40% during Q4.

Contact Details

Hottinger Investment Management Limited

27 Queen Anne's Gate
London SW1H 9BU

+44 (0) 20 7227 3400

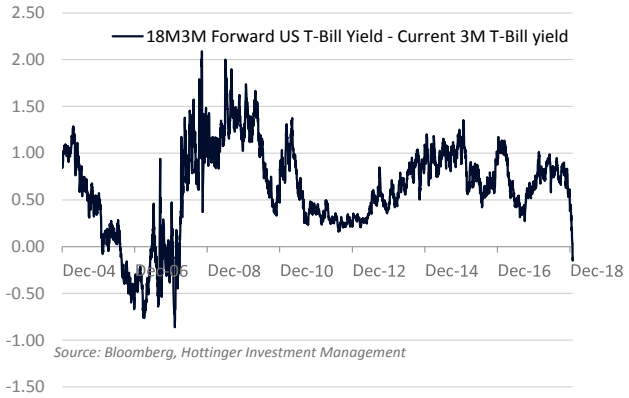
info@hottinger.co.uk

www.hottinger.co.uk

Based upon information available up to and including 15th January 2019

Key Issues in Charts

Markets price in rate cuts in 18 months' time



- Despite the decision in December by the US Federal Reserve to cut the number of interest rate rises it expects to implement in 2019 to two 25bp increases, the Bank remains behind the curve.
- This is because during the same month, as signs emerged that the global economy is deteriorating, markets think the economy cannot bear further monetary tightening.
- The spread between the 18-month forward for 3-month Treasury Bills turned negative in December, implying that markets think the Federal Reserve will cut interest rates by the middle of 2020.

Sentiment against emerging markets is turning

- Relative to the S&P 500 index of the largest U.S. companies, emerging markets outperformed in the final three months of 2018 , driven by US weakness rather than emerging market strength.
- Concerns with high levels of dollar-denominated borrowing in many developing economies and expectations of dollar strength create challenges for borrowers.
- A softer dollar this year combined with a less aggressive Federal Reserve could be positive for emerging markets equities.

Half of global stocks fell into 'bear market' territory in Q4

- 2018 was a negative year for most global equity markets. China and Emerging Markets were the worst performers, followed by Europe and the UK, while US equities mostly held their value until December despite increased volatility.
- The chart shows that we have been here before in recent years, but this time is different. When global markets retraced in 2011 and 2016, global central banks undergirded financial markets and supported conditions for asset price inflation. Today, central banks are steadily removing that support, creating a new period in which greater volatility and price discovery dominate markets.

A new perspective on passion investment: Hottinger Investment Circle

By Emily Woolard, *Strategy & Marketing Manager at* ***Hottinger Group***

The 2007/08 global financial crisis undoubtedly shattered investors' confidence and led them to retreat to traditional 'safe havens' such as government bonds, shying away from risk as far as possible.

Echoes of the financial crisis continue to reverberate and the current political uncertainty is proving to be a new kind of headache. Central bank interest rates remain stubbornly low in developed economies (some even negative, namely Japan, Sweden and Switzerland), suppressing returns in public markets. Further, in 2018 the FTSE 100 dropped by over 12% and the NYSE composite was not far behind.

Yet we have found that clients are increasingly hunting for inflation-beating returns and demanding innovative solutions to the conundrum of wealth allocation. With returns from public market low and volatility now rising, it's easy to see why long-term investors who are willing to take risk are looking elsewhere for returns.

"Clients - in today's markets more than ever - need their advisers to think creatively about the ways in which they put their wealth to work."

Clients - in today's markets more than ever - need their advisers to think creatively about the ways in which they put their wealth to work.

Private companies as a passion investment?

Passion investments typically include wine, jewellery, art, classic cars and other collectibles. They are multi-purpose by virtue of being a potential source of future value and providing diversification benefits in a portfolio as well as being items that the investor desires and is excited to own. The relative importance of each of these factors will of course vary depending on the investor and portfolio in question.

"...there is arguably little that entrepreneurs feel more passionately about than the industry and sector in which they themselves have achieved success."

Investments in unlisted companies don't typically form part of any passion investment list, but there is arguably little that entrepreneurs feel more passionately about than the industry and sector in which they themselves have achieved success.

As with many other passion investments, when it comes to private companies an investor's behaviour after purchase can materially influence the future performance of the investment. Take art and wine, for example, where knowledge and execution of the best storage and preservation techniques help to safeguard and increase value. In the same way, a successful entrepreneur with knowledge, experience, connections and perhaps the benefit of hindsight can provide invaluable mentoring and support to a nascent business and add significantly to its prospects through their involvement.

At Hottinger, we delight in helping to make connections and cementing mutually beneficial partnerships. We subscribe to the view that direct private investments are passion investments with rewards for both sides that reach well beyond the potential financial returns. For this reason and more, we have launched the Hottinger Investment Circle.

"At Hottinger, we delight in helping to make connections and cementing mutually beneficial partnerships."

Hottinger Investment Circle

Hottinger Group launched its members'-only Investment Circle at the end of 2018, providing potential investors with access to direct, off-market private equity, private debt and art investment opportunities through a dedicated online platform.

Responding to sustained demand from clients and external contacts seeking interesting and high quality private deal flow to supplement traditional wealth preservation strategies, *Hottinger Investment Circle* allows members to access and review a range of alternative investment opportunities before connecting them directly with the entrepreneurs behind the deal.

Innovation is nothing new for Hottinger - the family name is steeped in history and its members have been a prominent and pioneering force in the world of financial services since 1786.

Hottinger Investment Circle takes its name from a famous painting by James Tissot, The Circle of the Rue Royale, which celebrated its 150th anniversary in 2018. The work depicts Baron Jean-Conrad Hottinger gathered with eleven of his fellow club members in Paris. Like many of today's private investors, the twelve subjects collaborated to invest in cutting-edge venture capital deals of their time, even pooling funds together to commission the painting itself.
By virtue of Hottinger Group's extensive network, we often become aware of interesting off-market opportunities and we recognise the value of incorporating these into some of our clients' investment strategies. Hottinger Investment Circle brings a selection of deals together in one place for members to review at their leisure.

"Suitable only for experienced investors who can tolerate the increased risk of private investments, Hottinger Investment Circle is a non-advised, introduction-only service."

Suitable only for experienced investors who seek potentially higher returns but can tolerate the increased risk of private investments, *Hottinger Investment Circle* is a non-advised, introduction-only service. Following a review of their experience and circumstances, members will pay an annual fee to access the platform. For more information on how to become a member, please contact info@hottinger.co.uk.

Risk Warnings
Investments accessed via Hottinger Investment Circle will usually be in the shares or debt securities of private, unlisted companies, or secured lending to these companies, which might also be start-up or early stage companies.
We regard these investments as appropriate only for high net worth and sophisticated investors i.e. those who can understand and bear the risks involved, which may include a loss of some or all of the capital invested. The below list is

not exhaustive but the risks of investing in businesses such as these are likely to include:

Potential loss of capital
Investments will be in non-readily realisable securities and similar investments, issued by unlisted companies. These companies may have a limited track record and operating history. You may lose some or all of the capital invested.

Illiquidity
Investors should note that an investment of this type is highly illiquid and its value is volatile and can suffer from adverse or unexpected market moves. There is unlikely to be any secondary market or other clear means of exiting any Investment other than if the company sells its shares or arranges a flotation of its shares on a stock exchange or other market.

Unlimited duration
There is no time limit for investment in the types of investment available via Hottinger Investment Circle. It may not be possible to liquidate, redeem or withdraw from any Investment. Investments should be regarded as long term.

No dividends or other income
Early stage and start-up companies rarely pay dividends. You should not look to any investments available via Hottinger Investment Circle as likely to provide any income in the foreseeable future. Investments may pay interest on loan instruments or dividends, others may not and you should not look to any investment in a company entered into as a result of using the Service to provide you with a reliable income.

Dilution
Investments are likely to be subject to dilution. This means that if the company raises additional capital at a later date, it will issue new shares to the new investors, and the percentage of the business that you own will decline. These new shares may also have certain preferential rights to dividends, sale proceeds and other matters, and the exercise of these rights may work to your disadvantage. Investments may also be subject to dilution as a result of the grant of options (or similar rights to acquire shares) to employees of, service providers to or certain other contacts of, the Company.

Tax
You should take appropriate advice on the tax consequences of investing. The tax treatment of the investments available via Hottinger Investment Circle may depend on your individual circumstances. Schemes for tax reliefs (such as the EIS and SEIS schemes) depend a range of issues on the circumstances of each investor and can be changed or withdrawn.

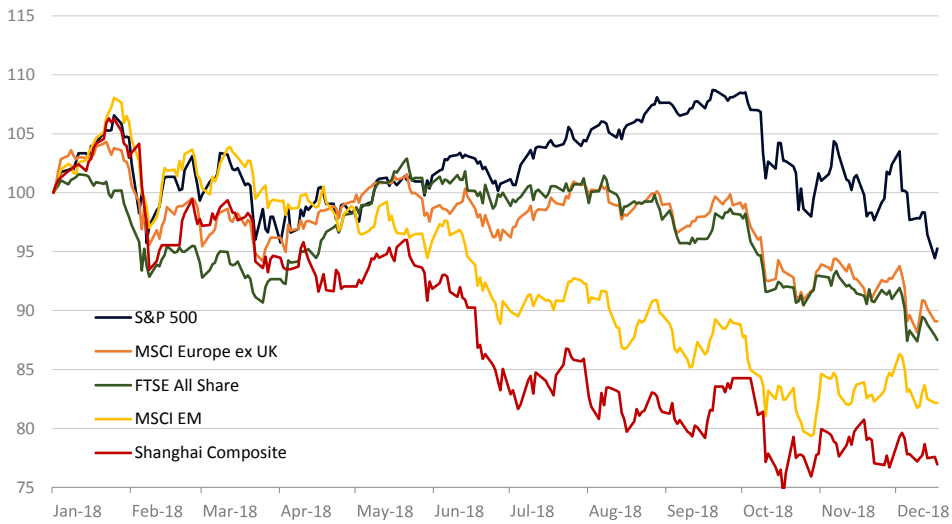
You should only invest through Hottinger Investment Circle as part of a diversified portfolio containing a range of investments of different types and risk categories. You should not invest more than you would feel comfortable to lose.

Macro View

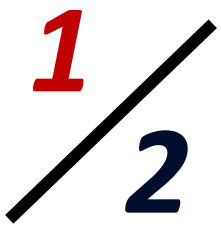
The last quarter of 2018 saw global economic activity continue to decelerate, led by two of the three locomotives of growth, China and the European Union. The United States, the third engine, has also likely cooled in the last three months, struggling to sustain the breakneck pace of expansion it enjoyed in the middle of last year.

Many global financial markets ended the year weaker, with the MSCI Emerging Markets index and the Shanghai Composite down by over 17% and 22% respectively, the MSCI Europe ex-UK and FTSE All Share (UK) down by around 10%, and the S&P 500 closing the year down 5%. The VIX index, which tracks market volatility, ended the year at an elevated level. Overvalued equity markets have responded to weaker than expected global activity despite the fact that world growth still remains reasonably strong and inflation is generally low. Global growth is likely exceeded 3.5% in 2018; fundamentals are still good.

A turn in economic sentiment has hit global financial markets (Jan 2018 = 100)



Data correct up to 18th December 2018. Source: Bloomberg, Hottinger Investment Management.



"Half of the stocks in the MSCI World index have fallen into bear market territory."

By December, over half of the stocks in the MSCI World index had fallen into bear market territory, defined as a stock's falling by over 20% from its most recent high. In the last ten years since the financial crisis, a period that represents the longest bull-run since the Second World War, this situation has happened on two other occasions (2011 and 2016) before resuming positive performance. But in those cases, loose monetary policy and high liquidity underpinned the market.

"This time is different because all of the three largest central banks – the Federal Reserve, the European Central Bank and the People's Bank of China – have radically decreased the degree of stimulus they are willing to provide."

This time is different because all of the three largest central banks – the Federal Reserve, the European Central Bank and the People's Bank of China – have either embarked on a process of monetary tightening and deleveraging or radically decreased the degree of stimulus they are willing to provide to their econ-

omies. As real interest rates rise and quantitative easing ends, money growth will slow and credit will become expensive, creating greater market volatility and a generally tougher time for financial assets and the real economy.

United States – All eyes on the Federal Reserve

"Indications of softening consumer confidence suggest that the US economy cannot sustain its current rate of growth."

Jay Powell's Federal Reserve was the focus of the market's attention, and indeed that of the US President, during Q4 2018 over concerns that the Bank might kill the strong US recovery. Whereas markets outside the US underperformed in the first three quarters, it was US equities that suffered the brunt of negative sentiment in Q4.

We await the fourth quarter figures but indications of softening consumer confidence suggest that the US economy cannot sustain its current rate of growth. While GDP expanded by 3.5% (annualised) in Q3 with a 4.0% (annualised) rise in consumer spending, core inflation has struggled to push through the 2% barrier and investors expect future inflation to be lower. Overall, the US is likely to turn in a 3% rise in GDP over the 2018 calendar year with unemployment at a 49-year low of 3.7%.

At Hottinger, we have been concerned for some time that expectations from the market of interest rate moves by the Federal Reserve were much more limited than those of the governors who make the policy. The spread on the US Overnight Index Swaps – important interest rate derivatives – can give an indication of what the market thinks interest rates will be in one year's time. Throughout most of the fourth quarter that spread pointed to a 25 basis point (bp) rate rise in December last year – which transpired – and then barely more than one rate rise in the first nine months of 2019. The Federal Reserve had pointed to three rate rises by the end of 2019 until December's meeting, after which they revised their median forecasts down to two rate rises.

"At the end of the year, the U.S. 1-year forward OIS implied only 15bps of tightening over the whole of 2019."

This still leaves a gap between the market and the Bank's interest rates expectations for 2019 of around 35 basis points because in the last two months, markets have been pricing in an even less restrictive policy. At the end of the year, the U.S. 1-year forward OIS implied that interest rates would not rise for the whole of 2019, while in the Eurodollar market for short-term offshore dollar deposits, investors were at one point in December betting that the Fed would cut rates in 2020. Market participants seem to have wanted the Fed to stop future rate rises altogether, so the new policy of two 25bp rises in 2019, announced at the December meeting, has done little to calm jitters.

The neutral rate of interest, a theoretical concept, informs the Federal Reserve's interest rate policy. Investors think that the neutral rate – the rate that moves to higher above which start to damage the economy – is much lower than what the Bank thinks it is. Because policy overshoot is a very common cause of domestic recessions and because the interest rate policy of U.S.

affects other regions – particularly emerging economies, global financial markets have reacted strongly to what they perceive to be a hawkish stance from the Federal Reserve. In early January, the Federal Reserve attempted to allay market concerns by saying it is open to a more flexible, event-driven policy.

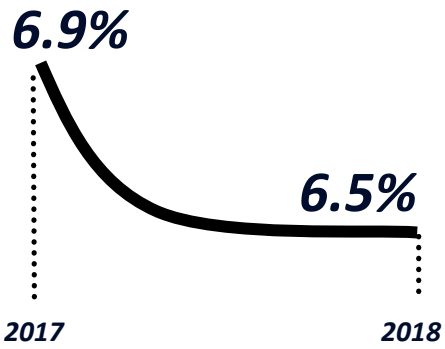
Despite pressures for it to weaker, the dollar could stay strong or become even stronger this year.

Nevertheless, US President Donald Trump remains concerned that tight monetary policy conditions, by weakening the domestic economy, could jeopardise his chances of re-election in 2020. This raises the possibility that he moves to undermine the Bank's formal independence from the U.S. Treasury or maintain a high fiscal deficit into 2020 that could raise the rate of inflation and the yields on long-dated government bonds.

In any case, fewer U.S. rate rises and more restrictive moves by other global central banks could reduce the pressure on the U.S. dollar to appreciate into 2019. However, the U.S. will still likely offer relatively high real interest rates, and heightened uncertainty in other regions such as Europe and China leaves open the flight-to-safety channel into U.S. assets. These countervailing pressures suggest the dollar could stay strong or become even stronger. Meanwhile, if the Federal Reserve eases the pace of tightening, there is a low chance that the U.S. will suffer a recession this year as economic fundamentals on growth, consumer confidence and employment remain strong.

China and Emerging Markets

The Chinese economy slowed to an annualised growth rate of 6.5% during Q4. Indicators of activity point in different directions. Declines in the growth of investment in infrastructure were offset by rises in real estate and manufacturing investment.



Soft landing? "The Chinese economy slowed to an annualised growth rate of 6.5% during Q4."

However, growth in Chinese imports, which reached annualised rates of over 15% through 2017 and the early part of 2018, took a nose dive in Q4 – suggesting softer domestic demand. Despite a weakened yuan, export growth also decelerated in November 2018, indicating softer global demand. The impressive international trading activity during H1 2018 appears to reflect front-loading activity by businesses looking to avoid new tariffs between the United States and China this year. If U.S. tariffs on $200bn of Chinese imports get called off and Presidents Trump and Xi agree a trade deal, we'd expect volumes to rebound.

The People's Bank of China reduced further the amount of cash that banks must hold in reserve — the reserve ratio requirement — during Q4 2018 and further efforts to ease policy and encourage banks to lend could be in the offing this year. However, the Bank continues to walk a tightrope between economic stability and financial stability.

One the one hand, the PBoC's clampdown on credit has most likely had its strongest impact on dampening infrastructure investment. On the other, mid-

dle class savers have been caught up in the wave of peer-to-peer lenders and wealth management product providers that have gone bust as a result of a rise in corporate defaults hitting China's shadow banking sector.

Easing monetary conditions generally could loosen controls on shadow banks, raising the threat of default risk and exposing middle class consumers to wealth shocks. With corporate default rates well below 1%, however, authorities may take the view that the costs of monetary easing are sufficiently low. There are also suggestions that the central government will try to stimulate the economy through large tax cuts amounting to 1% of GDP, which could radically change the outlook for the country and the region.

In wider emerging markets, we have seen sentiment easing as a result of a fall in the scarcity of the dollar, as indicated by the continuing decline in dollar hedging costs. Given evidence that emerging market central banks closely tie their interest rate policy to the Federal Reserve, the effect of a less aggressive schedule of U.S. rate rises could be positive for emerging economies this year, excepting those states that are highly exposed to low oil prices.

"In wider emerging markets, we have seen sentiment easing as a result of a fall in the scarcity of the dollar."

Europe

Europe has continued to decelerate in Q4, affirming the concerns we raised in the last edition of Global Insight about the dependence of the region on growing its export share to the wider world economy and accommodative policy from the European Central Bank. Economic output in the third-quarter fell by 0.2% in Germany, Switzerland and Sweden. Output was flat in Italy. However, Germany should rebound modestly as its automobile sector adjusts to new EU standards on emissions. More broadly, indications of producers' activity point to modest growth much closer to post-financial crisis average rate of around 0.3% per quarter for the region as a whole, although the *gilet jaunes* protests in France may have suppressed growth in Q4.

There are also signs that the euro area's domestic economy could pick up the slack from any deterioration in the trading outlook this year. Employment rose by 1.6 million in the first three quarters of the year; wages grew by 2.7% in the third quarter, greater than headline inflation (circa 2%) and significantly more than core inflation (circa 1%). The precipitous fall in oil prices should ease both consumer and producer price pressures, boosting consumption and exports. Growth could remain above the euro area's low trend rate of around 1.5% per annum.

*"Economic output in the third-quarter **fell** by 0.2% in Germany," but largely due to troubles with car-makers adapting to new EU regulations.*

Nevertheless, markets are pessimistic about Europe's prospects for 2019. In January 2018 investors expected the cost of short-term borrowing in December this year would be about 20 basis points. Today they think it will be -20 basis points. In other words, markets now expect there to be no interest rate rises in Europe this year, whereas at the start of 2018 they expected at least one interest rate rise during 2019.

ECB President Mario Draghi indicated in December that interest rate policy will remain flexible to economic conditions but he confirmed the end its $3 trillion bond-buying programme. Proceeds from maturing government bonds will be reinvested but for now the ECB will not be adding more sovereign bonds to its balance sheet. The combination of the absence of the Bank as a net buyer of sovereign bonds and the likely increases in fiscal deficits in both France and Italy in 2019 could put upward pressure on long-term interest yields in some countries least equipped to deal with them. However, the gains from any fiscal stimulus could offset the losses from the end of monetary stimulus and the effect on yields, at least in places that have low sovereign risk, could reflect merely an uptick in inflation.

"Facing headwinds from global trade and monetary conditions, Europe may come to rely on domestic demand and fiscal policy to drive growth."

Going into 2019, Europe does not look to be the stand-out performer that it did at the start of last year. Facing headwinds from global trade and monetary conditions, Europe may come to rely on fiscal policy to drive growth.

United Kingdom

After posting robust growth figures for Q3 (+0.6%), the UK economy has also show signs of deceleration. In the three months to October, the economy expanded by 0.4% according to the Office of National Statistics. Despite wage growth of 3.3% annualised in the three months to October and falling inflation (2.3% in November), consumer confidence as measured the GfK index – which takes into account personal financial situation, purchases and perceptions of the economic environment – fell to its lowest levels in five years.

The prospect of weaker domestic demand is concerning, because while UK business confidence remains broadly in line with the rest of Europe the UK has fallen well short in investment spending. Uncertainty surrounding the shape of Brexit has meant that UK businesses have not taken part in the upswing in investment activity during 2017 and the early part of 2018. Whereas many other developed economies invested significantly over this period, capital spending in the UK was flat. Continued political uncertainty as Brexit gets closer could start to have a greater negative effect on UK GDP as consumers, investors and businesses hold back on their plans.

"Continued political uncertainty as Brexit gets closer could start to have a greater negative effect on UK GDP as consumers, investors and businesses hold back on their plans."

Conclusion

The global economy lost some more momentum over the last quarter of 2018 but it still looks reasonably strong going into this year. The prospect of continued fiscal stimulus in the US, moderate public spending in France and Italy, tax cuts in China could offset the effects of more restrictive monetary and credit policies on markets and the real economy. However, risks to the downside broadly remain. The Federal Reserve could overshoot, the cold US-China trade war could turn hot, and political difficulties in Europe could interact dangerously with a weakening economic outlook.

Investment Outlook

The calendar year 2018 has been a difficult year for investors, particularly multi-asset investors, due to the number of different asset classes offering a negative real return – including US equity markets – following the anxiety exhibited in the 4th quarter. There has also been a return to normal levels of volatility, which has felt distinctly uncomfortable for some after the benign 2017 environment.

"There has also been a return to normal levels of volatility."

As an example, JP Morgan Asset Management calculated that the S&P500 moved by more than 1% on a daily basis ten times during the volatile month of October while only managing that feat 8 times in the whole of 2017. The sharp reversals between sectors and styles have also led to many false starts to any meaningful rotation away from cyclical and growth stocks until the significant capital flight in December.

The advent of Quantitative Easing (QE) brought with it a move away from market fundamentals towards political and central bank influence over investors. Arguably, the existence of a central bank back stop caused a reduction in volatility that favoured risk assets. As QE turns to QT (quantitative tightening) and economic strength is left to stand on its own feet a return to normal volatility in the latter stages of an economic cycle is to be expected especially if signs begin to show that the economy is also turning.

Another important development during the year was the return of a positive albeit small real yield on US dollar cash. As we noted in April, a large increase in the issuance of US Treasury Bills saw the yield move above 2.05%, then a medium term high, while 1 year US Treasuries yielded 2.38% against a 12m trailing dividend yield of 1.95% on the S&P500.

In our opinion, this was an important development for investors who had coined equities in 2017 the "TINA" trade (there is no alternative) because there now exists a low risk choice with a real return to increasingly expensive US equities. The fact that the 12-month trailing dividend yield for the S&P500 also moved below the return on cash meant that many "bond tourists" that had turned to the equity market in their hunt for yield now had a risk-return decision to make. Since then, markets have had to come to terms with the prospect of a significant slowing in earnings growth in the 4th quarter and some direct talking by Federal Reserve Governor Powell that has caused a re-assessment of the global outlook.

"The strength of the US economy has stood in direct contrast to other regions that have struggled with the mixture of factors including dollar strength, rising conflicts over global trade, geo-political risks and slowing growth."

The strength of the US economy has stood in direct contrast to other regions that have struggled with the mixture of factors including dollar strength, rising conflicts over global trade, geo-political risks and slowing growth. It could be argued that the removal of liquidity caused by the increasing move from QE to QT has been fundamental in slowing the global economy, from the four 2018 rate hikes in the US and the move to cease expanding the level of QE in Europe

"UK equities may look relatively cheap on a global basis but they remain unloved and under-owned."

to the management of bank lending in China.

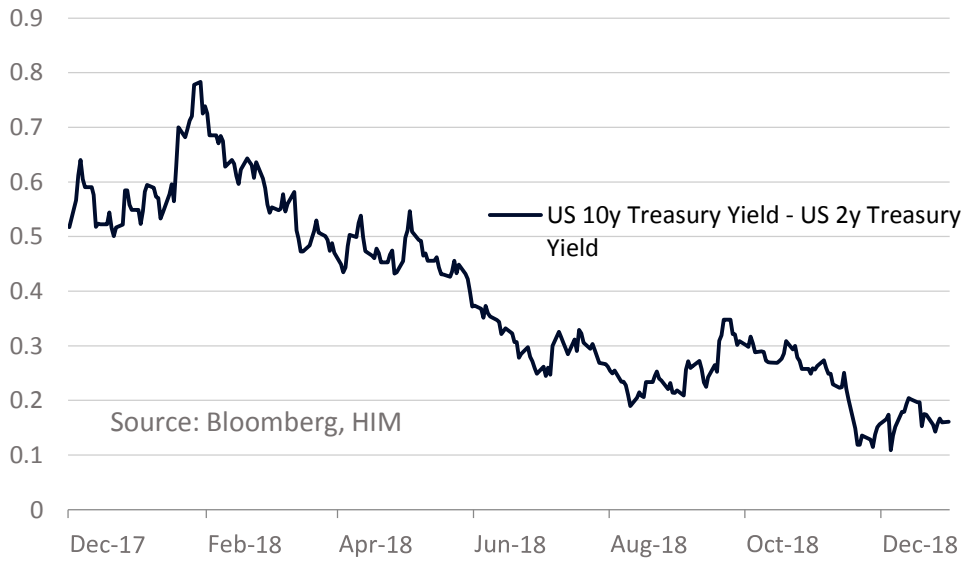
In its own way the uncertainty surrounding Brexit negotiations has contributed, having led to a significant lack of business investment in the last part of the year as UK-based companies stand back from making any new commitments. UK equities may look relatively cheap on a global basis but they remain unloved and under-owned. It looks as if Parliament is going to go down to the wire with an increased probability of a "no-deal" Brexit that would be very harmful to the UK economy, at least in the medium term, not to mention the EU economies that are already struggling with a China slowdown and US protectionism.

It is expected that global growth will weaken further in 2019 which explains the renewed interest in the shape of the US Treasury 2–10 year yield curve, which has been very flat for some time and the mild inversion at the very short end most recently. At the time of writing the yield differential between 2-year and 10-year was 0.18%, or 18 basis points, which leaves very little reward to the investor for taking duration risk.

This has also had a significant effect on bank shares in the developed world which have become increasingly under pressure with many in bear market territory (down 20% from their previous peak). There is also concern that European QE has pushed European banks into US corporate bonds due to low yield on European Government bonds due to the ECB's yield-compressing bond buying QE programme, leaving these banks overly exposed to US currency and potential corporate default risk.

"It is expected that global growth will weaken further in 2019 which explains the renewed interest in the shape of the US Treasury 2 –10 year yield curve."

The 2-10 year yield curve continues to flatten



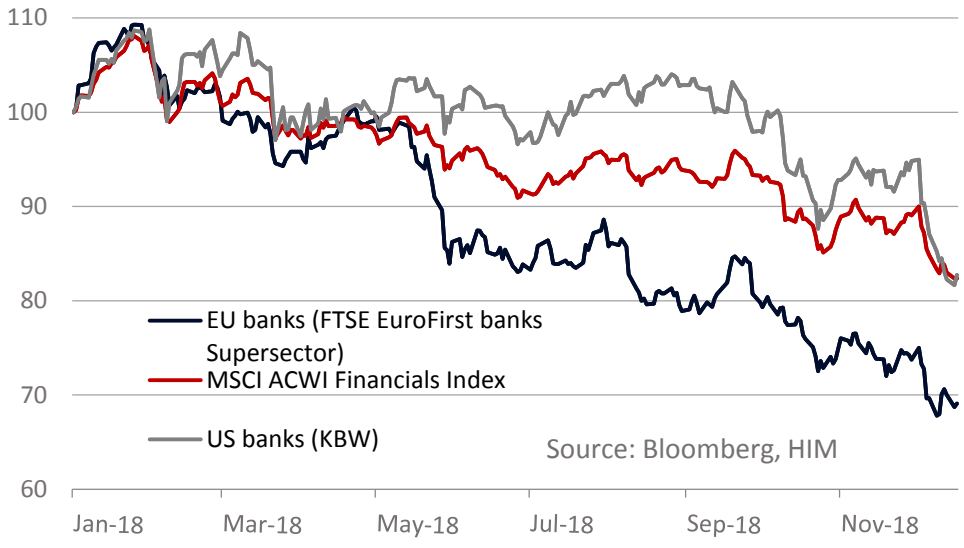
The bond market's ability to signal stress within the economy has been severely disrupted since the beginning of QE given the persistently flat yield curve that would normally signal an economy that is about to roll over into recession.

The move to QT is removing the guaranteed buyer i.e. central banks although the effect of this has been somewhat dulled by aggressive forward guidance so as not to upset the market, combined with the continued buying by insurance companies. A return to fundamentals may well see the Treasury yield curve regain some of its predictive qualities but the likelihood of continued central bank intervention may continue to cloud its judgement. Although we may be looking at slowing global growth and US growth returning to the global average as the tailwind of fiscal stimulus recedes, there have been very few predictions of recession over the next 12 months.

"The bond market's ability to signal stress within the economy has been severely disrupted since the beginning of QE."

However, investors should probably position themselves for lower earnings growth in 2019 with a more cautious asset allocation that favours short-dated bonds over risk assets.

European banks' share prices fell significantly over 2018



Meanwhile, the performance of bank shares, particularly in Europe but also more recently in the US, raises the question as to the ability of financial markets and the wider economy to withstand a normalisation of monetary policy. It may be that the tightening bias that seems appropriate from the headline economic statistics may trigger unexpected stress in the financial markets. The forecasts for QT may be too aggressive, leaving central banks the difficult task

"The performance of bank shares, particularly in Europe but also more recently in the US, raises the question as to the ability of financial markets and the wider economy to withstand a normalisation of monetary policy."

0.22%

"The 10 year German Bund remains stubbornly low."

of finding the right policy path.

The yield on the 10 year US Treasury reached 3.25% in October when the outlook for US rates was deemed too aggressive before rallying to 2.65% as US equities suffered a torrid December – the S&P500 fell 9.18%. At inflection points, it is often the case that previously uncorrelated assets move together through short term stress, as seen in February and October, so the resumption of a position relationship between US bonds and equities is encouraging.
On the other hand, European investors have been in need of a risk-free, real-yielding asset due to the significant slowdown in growth and ongoing political risks but the 10 year German Bund remains stubbornly low at 0.22% (negative after inflation), despite the prospect of ECB QE tapering in 2019.

With regards to China, the authorities continue to attempt to strike a balance between overheating credit growth and above average GDP growth while trying to negotiate with the hostile trade policies of the Trump administration. The recently announced agreement between Trump and Xi will provide some market encouragement, however, the negotiations will be continuing through 2019 accompanied by the expected high levels of theatre.

In summary, 2018 was a year of negative returns in most asset classes as monetary policy becomes less accommodating and it is likely that 2019 will see slowing earnings, slowing growth and continuing high levels of central bank and government influence over financial markets clouding fundamentals. Investors will need to be cautious if they are to navigate their way and preserve capital.

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