July 2019
Issue No. 12

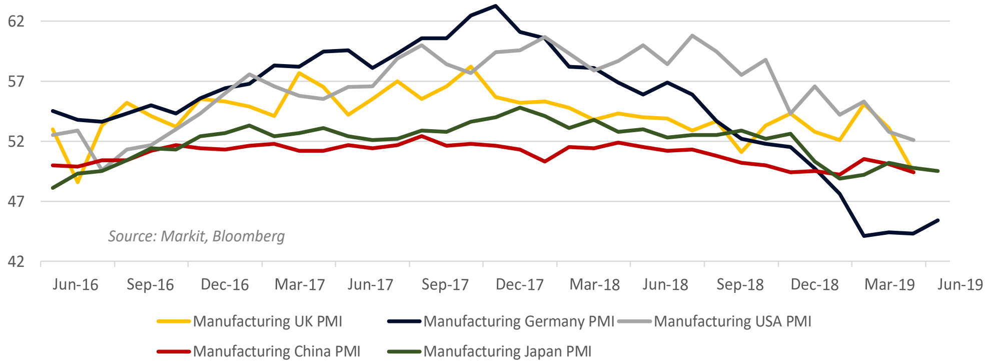
HOTTINGER GROUP

GLOBAL INSIGHT

Overview

- There is one converging point of view between the otherwise very different worlds of art and wealth management: Collectables can be an investment opportunity.
- In our **feature article,** Melanie Damani, Managing Director at Hottinger Art, reviews the state of the global art market and explores the wider intrinsic benefits of investing in art.
- In our **Macro View**, we cover the ongoing trade dispute between the United States and China and how this has put the brakes on global manufacturing activity.
- The three months to June continued a period of broad concern over the development of the world economy. Measures of business sentiment, industrial production and new manufacturing orders remained suppressed in all the major regions between April and June. We, however, try to look for bright spots in each region.
- In our **Investment Outlook**, we assess activity in the second quarter as markets recover from allayed fears over the US-China trade standoff and a hawkish Federal Reserve.
- Whilst equity valuations are looking reasonable, more so than bonds, the fundamentals look weak. Corporate confidence and capital expenditure have been damaged by the political environment and these factors are feeding through to the bottom line.
- Whilst the bond market reflects investor pessimism, should the political landscape start to resolve and subsequently restore corporate confidence, this should prove to be a tailwind for markets, translating into earnings and subsequently valuations.

Trade tensions are a major factor in weaker global manufacturing sentiment



Inside this issue

Economic Highlights

- German factory orders fell by over 8% in the year to May 2019.
- Global investors bet on cuts to US interest rates of 100 basis points.
- China has cut taxes by $130bn in efforts to stimulate economy.
- UK wages continue to grow in excess of inflation.

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Based upon information available up to and including 12th July 2019

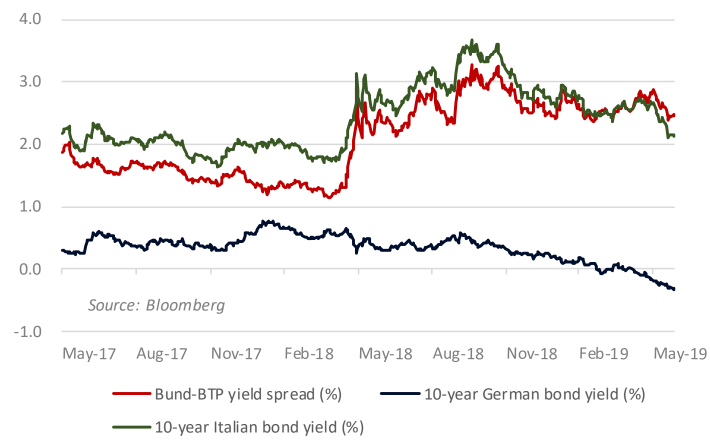
Key Issues in Charts

Chinese export and import growth has stagnated

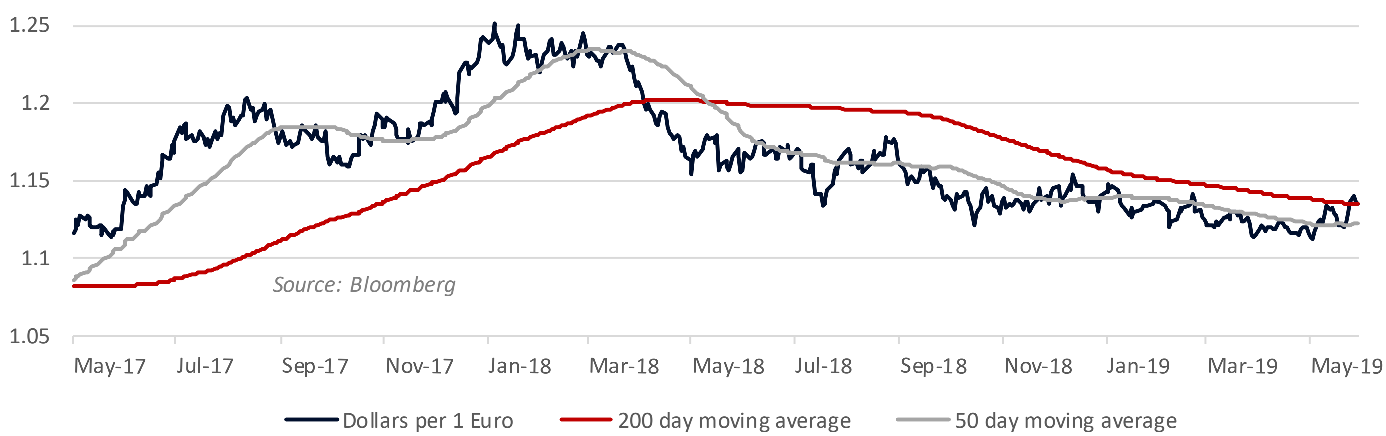
- It has not been uncommon to see China's exports and imports grow by well over 10% on an annualised basis over the last few years.
- Over the last quarter, exports have stagnated, barely up on last year; and at the end of May, imports were 8.5% lower than 12 months earlier, as data from the General Administration of Customs indicate.
- Weak trade volumes suggest that China's efforts to stimulate could be outweighed by the effects of the ongoing trade standoff with the United States.

In global bond rally, investors park the Italian question

- The yield on 10-year German bunds reached a record low during Q2 2019 and fell further in July—to as low as –0.4% — before modestly recovering.
- Investors sought safe haven assets and bet on a new round of stimulus from the ECB as global growth slows.
- Italian bond yields fell further and in mid-July Italian 10-year bonds were yielding at levels last seen before the creation of Italy's ruling populist coalition. Yet Italian political risks have clearly not receded.



In a race among central banks to ease policy, could a weakening Euro trigger a backlash from President Trump?



- As the global trade cycle started to cool in 2018, the euro has steadily weakened against the dollar. In June, the US President Donald Trump accused the European Central Bank (ECB) of being a 'currency manipulator' for using supportive monetary policies to allegedly keep the euro cheap.
- With outgoing ECB governor Mario Draghi steering the bank towards a new round of QE or cuts to interest rates, the effect could be for the euro to weaken further in H2 2019, especially if the Federal Reserve undershoots aggressive market expectations of its own policy.

Considering art as an investment

By Melanie Damani, *Managing Director at* ***Hottinger Art Limited***

There is one converging point of view between the otherwise very different worlds of art and wealth management: Collectables can be an investment opportunity. The aim of this article is to provide an overview of the art market from an investment perspective. Hottinger Art can assist you with any questions you might have regarding this topic, as we provide a safe, easy and confidential place to deal with art and collectables.

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A year ago, key metrics in the ArtTactic Global Art Market Outlook showed a positive trajectory for the global art market, with increasing market confidence and a positive outlook for the global modern and contemporary art markets. Last year ended on a positive note. Global auction sales from Sotheby's, Christie's and Phillips were up 8.9% on 2017, and the Post-War and Contemporary sales in New York and London were up 5.9% on the previous year. However, market sentiment has taken a U-turn so far in 2019. Early this year, ArtTactic experts stated: "Global economic and political uncertainty could derail the fragile confidence of the buoyant art market in the coming 12 months."

And in fact, since January 2019, the global art market has been struggling against a backdrop of slowing economic growth, triggered by trade wars and the uncertainty around Brexit. The latest auction results, which give a sense of where the global art market is at, confirm this slowdown for the UK but interestingly the US showed steady growth in the same period . In London, the June Impressionist and Modern art evening sales raised a total of £115,360,000 (excluding buyer's premium), falling short of the total pre-sale estimate of £151,650,000–£211,050,000. The sales total was 37.7% lower than it was in June 2018, and 54.5% below June 2017 levels. Combined total sales for Sotheby's and Christie's over the past 2 and 5 years are down 54% and 35.5% respectively (source: ArtTactic, 2019).

Since January 2019, the global art market has been struggling against a backdrop of slowing economic growth, triggered by trade wars and the uncertainty around Brexit.

The outlook for the contemporary auction market is also pessimistic and the most recent June sales remain flat on the previous year despite Christie's rejoining the London summer sales. In fact, Christie's, Sotheby's and Phillips' post-war and contemporary art evening sales raised £126,115,000 this week, just above the pre-sale low estimate – (expected range was £125,620,000 - £180,960,000). The sales total was up only 2.3% from June 2018 – although Christie's was absent from the London contemporary evening season last year. Sotheby's evening sale came in 38% lower than last year, whilst Phillips evening sale came in 2% higher (source: ArtTactic, 2019).

In New York, the market is in a better place, but this is the exception at the moment. In fact, despite record prices being set for artists such as Jeff Koons and Robert Rauschenberg, the overall evening sales of Post-War and Contemporary evening auctions in May 2019 just scraped above the same figure of 12 months ago. By contrast, the Post-War and Contemporary Art evening sales in New York raised a total of $843,930,000 (excluding buyer's premium), comfortably within the total pre-sale estimate of $741,910,000 – $1,063,230,000 (source: ArtTactic, 2019). The discrepancy between the US and the UK art market re-emphasises the strong leading position the US has held for years. The UK remains in second place followed by Hong Kong, which was number two for several years until 2017.

Data on art performance often only refer to the sales of a small sample of expensive, high-profile works rather than the overall market.

When it comes to art performance and measuring returns on investment, looking at auction house results is one of the most common ways to measure the trends, simply because auction results are often the only data publicly available. The problem is that these data really refer to the sales of a small sample of expensive, high-profile works rather than the overall market. Numbers quoted by big auction houses like Christie's and Sotheby's relate to blue-chip works, rather than to the different tiers below them. Mid-market collectors will face different pressures and be more susceptible perhaps to tougher economic conditions than, say, collectors at the high end. Moreover, works that are in demand tend to go to auction more frequently as owners look to realise big profits. In addition, auction houses will generally only place items on sale that they believe will generate profits.

The overall effect of this selection bias is the potential overstating of returns as well as the understating of risk. In addition, the measurement of art performance is hindered by the fact that pieces of art are not "fungible". Unlike shares, bonds and commodities for instance, each work of art is a unique entity that cannot be replaced by another.

As difficult as it seems to be to quantify the performance of art & collectables, there are many examples which have provided a great return on investment. History has proven, though, that the greatest and most valuable collections were built by people who were fully invested and dedicated to their passion, continuously educating themselves on buying art almost to the point of becoming experts in their own right. More and more collectors nowadays work with art advisors who provide their expertise to assist them, for example by providing guidelines or parameters for acquisitions, helping them to avoid beginners' mistakes, providing them with a second opinion on a purchase, sourcing pieces for them or simply challenging their curation ideas, among many other things.

A collector may derive great joy from owning a particular work or group of works according to a theme or artist that cannot be captured in a simple return on investment.

In addition to financial returns, art buyers find that there is an intangible value attached to owning a work of art. This concept applies to all types of collectable assets such as classic cars, coins, wine or stamps, as well as fine art. A collector may derive great joy from owning a particular work or group of works according to a theme or artist that cannot be captured in a simple return on investment. Intangibles could include the joy of acquiring knowledge and insight into a movement or artists that accompany the acquisition of works over time, or it could be the joy of showing and discussing works with friends and colleagues. How to measure this intangible aspect is one of the greatest challenges for those trying to produce performance indicators equivalent to those of other types of investment.

Art funds can be an alternative to direct purchase of collectables. These allow exposure to art as an asset class, perhaps as a diversification play, without some of the storage and logistics challenges of direct ownership; however, the emotional or passion element of investment in art is also absent or at least one step removed. In 2019, art funds remain a niche service. Few wealth managers offer an art investment fund product as part of their in-house offering. Banks, on the other hand, are more able and seemingly keener to offer art investment fund opportunities to their clients, although usually through a limited number of third-party providers.

However, in their 2017 Art & Finance report, Deloitte and ArtTactic reported that the art fund market was struggling to gain momentum, and it has not picked up significantly since them. The overall art fund market was worth $834m in 2018 (down from $1.3bn in 2016). The decrease in the overall AuM in the art fund market – which began in 2012 - is partially due to the Chinese art funds and tougher regulations implemented from 2016 onwards. The challenges around art funds include the fact that wealth managers find it difficult to assess their viability and credibility. In fact, this is true of the art market in general, due to the lack of track record and public performance data as well as the unregulated nature of the art market.

Another challenge of art investment and particularly art funds is linked to the post-investment monitoring, where the lack of mark-to-market valuation can prevent the incorporation of art into a traditional wealth management offering. On a more positive note, the market is confident that technological innovations such as blockchain will help new art investment products to develop, as well as improving transparency by recording and verifying all participants in a transaction.

In conclusion, art has been recognised as an investment opportunity for a number of years now. However, investing in art remains challenging, particularly with respect to performance measurement. Successful investors are - in most cases - connoisseurs who combine knowledge with passion and follow the motto: *Ars gratia artis* – Art for art's sake. Non-experts could think at first glance that art funds would to be an interesting and easy way to invest in art. However, the market has so far had a lukewarm response to this, and for some the loss or dampening of the intangible elements of return on art investment renders such a method pointless.

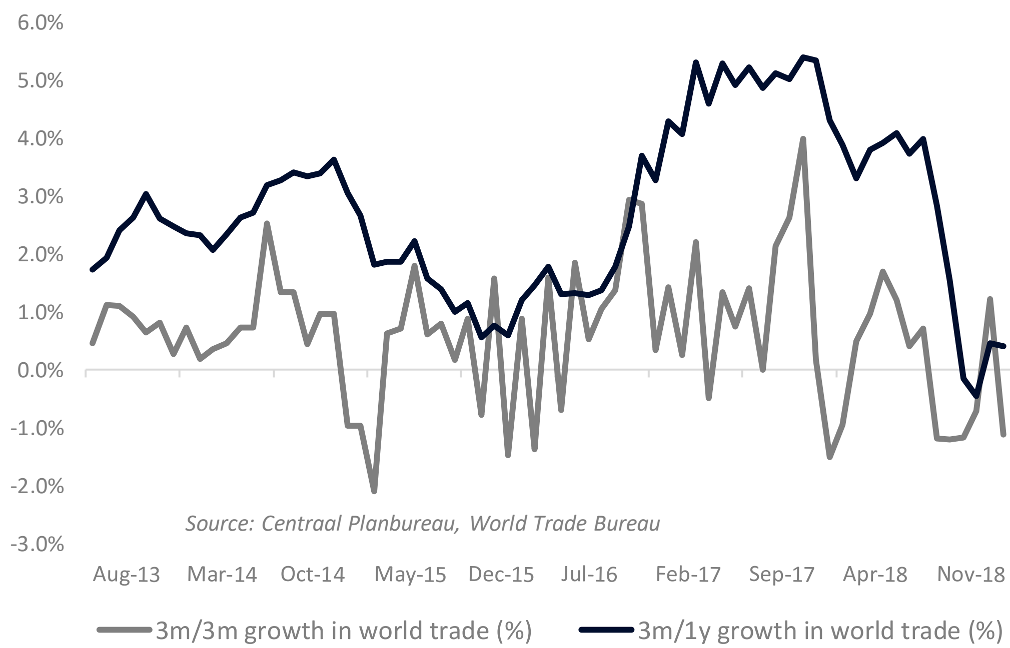
In a challenging and constantly-evolving environment, using an art advisor to navigate the art world and find opportunities could be a solution that works for both highly qualified collectors and newcomers on the market. To find out how Hottinger Art can help, please contact **melanie.damani@hottinger.co.uk**

Macro View

The three months to June continued a period of broad concern over the development of the world economy. Measures of business sentiment, industrial production and new manufacturing orders remained suppressed in all the major regions between April and June. South Korea's KOSPI-100 stock index, a useful proxy for world trade growth because of the country's heavy export-orientation, broadly weakened over the quarter.

However, there are a couple of bright spots that may point to an upswing in activity in the second half of this year. In China—the world's manufacturing hub —inventories of raw materials and finished goods rose steadily during the quarter, according to the country's National Bureau of Statistics. Additionally, the cost of shipping as measured by the Baltic Dry Shipping Index increased sharply in June, possibly reflecting stronger global trade volumes in recent weeks. This could suggest that the rise in Chinese inventories reflects stronger demand and not simply efforts by manufacturers to stockpile in the face of growing trade tensions.

Global trade growth has become anaemic in recent months



Chinese growth decelerated to 1.4% over the quarter, but there are signs that the government's efforts to stimulate are having some effect.

China

During Q1 2019, Chinese growth decelerated further to 1.4% over the quarter, trending below the government's 1.6% quarterly target. There are signs, however, that the China's efforts to stimulate are having some effect. 'Real M1', which measures the real value of bank deposits in China has started growing again, suggesting that cheaper interbank credit, lower RRRs and looser lending requirements may have facilitated loan growth. Whether this translates into a boost to growth remains to be seen. It has been widely noted in the last few years that credit expansion has been a decreasingly effective stimulant for economic activity, as rising leverage places an ever-greater countervailing force on business. According to the Bank of International Settlements, total debt to GDP increased from 120% in 2007 to 253% last September. Further, while ensuring credit remains adequate, the Chinese authorities have persisted in clamping down on shadow banking activities, which has ensured that overall credit growth in the economy has continued to fall.

Efforts to stimulate include the $130bn cuts in business taxes and VAT between January and May which were intended to encourage domestic-facing consumer spending.

Other efforts to stimulate include the $130bn cuts in business taxes and VAT between January and May which were intended to encourage domestic-facing consumer spending. There has indeed been a modest uptick in the year-on-year growth rate in retail sales to above 8.5%.

Nevertheless, export and import volumes have remained suppressed. It has not been uncommon to see China's exports and imports grow by well over 10% on an annualised based over the last few years. Over the last quarter, exports have stagnated, barely up on last year; and at the end of May, imports were 8.5% lower than 12 months earlier, data from the General Administration of Customs indicate. Weak trade volumes suggest that China's efforts to stimulate could be outweighed by the effects of the ongoing trade standoff with the United States. Ongoing weakness in car sales is particularly bad for Europe; according to the China Association of Automotive Manufactures, auto sales have fallen by 12.4% since the start of the year.

United States

Economic growth for the US during Q1 2019 came in strongly at 3.2% (annualized), but it obscured signs of underlying weakness. Contributions to GDP from consumption and non-residential investment was exceptionally weak in Q1, with a collapse in imports and a rise in inventories artificially raising the GDP figure. Forecasts for Q2 GDP growth issued by the Federal Reserve Bank of Atlanta indicate a slowdown to around 1-2% annualised growth. This is largely on the back of the fading effects of fiscal stimulus, weakening manufacturing sentiment and sagging auto sales reflecting stricter financing conditions for buyers. However, in May and June there was a moderate pick up in retail sales, allaying fears somewhat of an immediate US slowdown.

We think lower US consumer inflation reflects softening domestic demand and the associated weaker pricing power among firms.

US core consumer inflation continued to fall from its 2% target during the second quarter of 2019. We think lower consumer inflation reflects softening domestic demand and the associated weaker pricing power among firms as producer inflation and wage growth have remained moderate. If firms pass on the effects of US tariffs on Chinese imports onto consumers, and there are signs that this is already happening, inflation could move back towards the target during the second half of the year. If, however, inflation remains low, that would give cover to the Fed to maintain its dovish stance, raising the chance that it delivers a series of rate cuts this year, starting with one at the meeting planned for the end of this month.

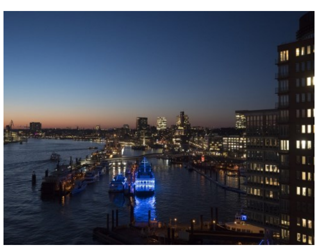
Financial market participants now expect three or four 25-basis-point rate cuts by the end of the year, and it will prove hard for Fed Chair Jay Powell to rein in these expectations without causing trauma in the markets. We think there is a significant risk, however, that investors will be disappointed by the degree of stimulus which Powell implements.

The effect of the trade standoff between the US and China is likely to be a major factor behind the slowdown in global activity.

The effect of the trade standoff between the US and China is likely to be a major factor behind the slowdown in global activity. During the quarter, the US government announced that the tariff rate on roughly $200bn of Chinese imports would rise from 10% to 25%. The Trump administration also announced that it would prepare for 25% tariffs on a further $325bn of imports that – together with the $200bn – make up almost all exports that China sends to the United States.

Although China responded with tariffs of its own, it is still possible that the two sides could agree a trade deal that unwinds these measures. Hopes that such a deal would have been reached at the G20 Summit of early July have since faded, and instead US President Donald Trump has brought Europe into the game by threatening tariffs of $25m on European exports and claiming that the eurozone's loose monetary policy is unfair. The problem here is that as Europe considers embarking on a new round of monetary stimulus that may have the effect of weakening the euro against the dollar, Mr. Trump's accusations may begin to acquire the slightest ring of truth.

Europe



Germany is uniquely exposed to the euro area and global economy in general and to China in particular.

We have previously argued that Europe's manufacturing sector has been at the heart of the region's weakening economy as a slowing China and trade tensions weigh on global demand and exports. It appears that despite some good news in recent months, the European economy remains highly sensitive to global developments and this is what is causing concern among investors.

In July, Germany's Federal Statistics Office announced the biggest monthly fall in German industrial production in four years, with factory output in May 2.2% lower than it was in the previous month. On an annual basis, orders were a rather shocking 8.6% lower than in May 2018 – the weakest reading since 2009. In June, the Bundesbank issued its latest forecast for the economy, cutting its 2019 prediction from 1.6% to 0.6%.

Germany is uniquely exposed to the euro area and global economy in general and to China in particular. World Bank data suggest that exports now account for over 45% of Germany's GDP, rising from 29% in 1999, when the euro area was formed. To put this in context, in the US export share is much lower, at roughly 12% of GDP and increased only modestly from 10.3% in 1999. Between 1999 and 2017, Germany grew its exports to China by over 1200%, from $7.3bn in 1999 to $97.3bn in 2017.

Other euro area states too have increased their dependency on each other and the wider global economy since the financial crisis, so weak performance in any European state is now a concern for all others. According to Eurostat, during April eurozone industrial production shrank at a month-on-month pace of 0.5%, a greater rate than the consensus of -0.3%. Among the bloc's other economies output was weaker in the Netherlands (-1.7%) and Italy (-0.7%); France and Spain performed better. However, compared to a year earlier, industrial output across the eurozone was 0.4% lower in April.

Europe's domestic economy has held up better on the back of rising wages, falling headline inflation and declining unemployment.

The domestic economy has held up better on the back of rising wages, falling headline inflation and declining unemployment. Business sentiment and confidence among European service firms have strengthened while Eurozone retail sales growth—though falling during the quarter—remains elevated.

Nevertheless, inflation expectations have been falling in the eurozone since the beginning of the year as the malaise affecting the export sector has outweighed any strength from the domestic economy. Traders have been pushing down the Forward 5y5y Inflation Swap Index, a proxy for future expectations for inflation, towards 1%. This is the lowest level for inflation expectations since at least 2004 and reflects the rally in several European government bonds, including the sovereign paper of Italy and Greece.

Just as in the US, investors are expecting monetary policies that increase liquidity and support domestic demand. Towards the end of the quarter, outgoing ECB governor Mario Draghi confirmed that the bank may restart more supportive action. However, with interest rates already at zero and a dearth of safe government bonds for the ECB to buy were it to restart QE, it is unclear what would amount to an effective monetary policy at this point.

However, as we have mentioned before, until there is meaningful support for aggregate demand in the euro area, it is difficult to justify the rally in European risk assets. Christine Lagarde, the IMF's Managing Director and likely next governor of the ECB, could inject some much needed energy into the European political debate and encourage better coordination between monetary and fiscal policies. This could mean low—possibly, even strongly negative—interest rates paired with public spending programmes that increase the supply of bonds for the ECB.

The UK economy experienced a volatile Q2 2019 in terms of growth, with a general trend towards slowdown emerging.

UK

The UK economy experienced a volatile Q2 2019 in terms of growth, with a general trend towards slowdown emerging. Figures from the Office for National Statistics released in June indicate that the UK economy contracted by 0.4% in April, attributable somewhat to a very large fall in car production as manufacturers brought forward the annual fallow period to that month to coincide with an anticipated March Brexit. It was the second consecutive month for which national output fell and leading indicators – such as the 1.3% decline in retail sales over the year to June and the broader stagnation of the all-important services sector – suggest that overall growth for Q2 could be too close to zero for comfort. The GDP figures for May (+0.3%) and the upward revision to the March figures, however, mean that it is far too soon to call an impending UK recession, especially vis-à-vis the wider European continent.

Sustained real wage increases could keep consumer spending buoyant in the coming months as the manufacturing and export sectors deal with the difficulties of the troubling global trading environment and the prospect of a hard Brexit.

The good news is that UK wages have continued to grow strongly, at 3.4% in June and 1.4% after inflation is considered. Sustained real wage increases could keep consumer spending buoyant in the coming months as the manufacturing and export sectors deal with the difficulties of the global trading environment and the prospect of a hard Brexit. It is this factor combined with strong UK employment data that left the Bank of England broadly neutral on interest rate policy over the quarter.

One cause for concern however is the drop in UK productivity – or, output per hour worked – for the third successive quarter, which will put upward pressure on companies' unit labour costs and could make further growth in nominal wages less likely to materialise. The 0.2% decline in output per hour in Q1 2019 was driven by a 0.9% decline in the manufacturing sector, reflecting the effect of years of low investment in new technologies on the back of uncertainty over the country's ongoing business and trading environment.

Conclusion

It has been clear since the beginning of the year that the world economy has been moving into a slower growth gear. International trade has stalled because of political tensions and the effect of the withdrawal of monetary stimulus last year. As of yet—and with the exception of the United States, which has maintained an elevated rate of growth—governments nursing high levels of public debt have been loath to increase public spending to support demand, but that time may come soon. It is too early to call an outright global recession as many investors in the bond markets appear to be doing by aggressively pushing down global yields, but we are preparing for a rise in trading volatility as economic indicators become more ambiguous and political risks remain.

Investment Outlook

The investment outlook is somewhat opaque. Some signs suggest the market has further room to run; housing markets are well supported, inflation is benign and unemployment is at 50-year lows. Others would suggest we are at the end of the market cycle, with the US yield curve inverting, capital expenditure stagnating and earnings expectations falling. The presence of these contradicting economic indicators has led to a divided consensus as to whether we are in fact late or mid-cycle. Political instability has not helped; China-US trade talks, Iran sanctions, Brexit and Theresa May's successor are a few to mention.

Falling bond yields reflects a broad concern about slowing economic growth and increasing concerns of a recession.

Fixed income

Bond yields are near historic lows as the yield on the US 10-year Treasury reached a 2-year low, yielding 1.75%. 10-year yields across the board have fallen since June. Over the quarter, 10-year US Treasury yield was roughly 40bps lower; the 10-year German Bund yield was down 25bps and the 10-year UK was 17bps lower. This move reflects a broad concern about slowing economic growth and increasing concerns of a recession.

Inflows have shown a preference for quality over yield with more demand for investment grade bonds over high yield bonds. US investment grade spreads over Treasuries fell 6bps over the quarter to 1.25% whereas US high yield spreads increased by 4bps to 3.95%. Corporate bonds also outperformed government bonds as corporate leverage is perceived to be manageable. Broadly, it was a positive quarter for most bonds following expectations that central banks would turn towards an accommodating monetary stance. Both the Federal Reserve (Fed) and the European Central Bank (ECB) expressed a dovish policy to come. Given the Fed's statement allowing for a modest overshoot in its inflation target, combined with its dovish stance, the likelihood for the yield curve to steepen is possible, invalidating any concerns surrounding the inverted yield curve as an indicator to an impending recession.

Historically, coupon income has comprised the majority of total returns for bonds, roughly 85% across all bond classes. Given the current level of yields, a reversion to the norm is plausible.

According to Blackrock, capital appreciations have contributed roughly 75% of US Treasury returns, testament to the high demand for bonds over the period. Historically, coupon income has comprised the majority of total returns for bonds, roughly 85% across all bond classes. Given the current level of yields, a reversion to the norm is plausible.

Rating agency downgrades have picked up in the US and Europe and are at post global financial crisis highs. Should the Fed ease rates as expected this will help corporates in servicing their debt and as such the rate of defaults could fall. With the upcoming 2020 US Presidential Election in his sights, Donald Trump will likely pressure the Fed into dropping rates in another effort to stimulate the economy to strengthen his campaign.

Equities

Equity markets remain propped up amidst optimistic expectations for trade resolution and accommodating central banks. European, British, Japanese and Emerging Market equities remain undervalued.

Equity markets remain propped up amidst optimistic expectations for trade resolution and accommodating central banks. European, British, Japanese and Emerging Market equities remain undervalued on a forward P/E basis. The US market in comparison is overvalued, trading above its historical average on a forward P/E basis. Whilst the equity market has performed relatively well over the quarter fundamentals are looking weak. US earnings are slowing as the effects from the tax cuts fade. Earnings downgrades are outnumbering upgrades and pressure on corporate margins does not help. Meanwhile, global capital expenditure (CAPEX) has reached multi-year lows as measured by capital goods imports, its proxy. Global PMIs are approaching multi-year lows and only one-third of countries tracked by Barclays reported a PMI greater than 50.

United States

The S&P hit an all-time high, rising 2.6% over the quarter on the back of the Fed's now dovish stance. This should not mask the risk of US-China trade talks breaking down but the effects of probable policy easing from the Fed have evidently had a positive impact on equity markets. Forward markets, which represent the current expectations on interest rates by investors, suggest the market is pricing in a move down from the 2.5% – 2.25% range by 100 basis points over the next 12 months. Questions remain as to whether this may be a repeat of the late 1990s where the Fed engineered an extension of the market's economic cycle with a series of rate cuts between 1995 and 1998. The extent of this rally has been enhanced following the recent G20 summit at which Donald Trump made the decision to delay the levy of further tariffs of 25% on over $300bn of Chinese goods. Whether this materialises into an end to the tariff war is unknown, but investors appear optimistic for the time being.

Forward markets, which represent the current expectations on interest rates by investors, suggest the market is pricing in a move down from the 2.5% – 2.25% range by 100 basis points over the next 12 months."

The more cyclical sectors of the US outperformed over the quarter; Financials, Technology and Materials remain the biggest gainers, returning 8%, 6.1% and 6.3% respectively. Defensive areas saw modest gains with healthcare seemingly challenged by legislative changes that may take effect. The US remains overvalued and given the perceived safe haven of the US dollar this could remain the case.

Performance of US equities will be dependent on corporate earnings and any developments on the trade talks. The direct impacts of the US-China trade talks remain manageable; US exports to China are 0.6% of US GDP and Chinese exports to the US are 3.6% of Chinese GDP, according to Absolute Strategy Research. However, the indirect effects are a cause for concern: disruption to supply chains, scale back of CAPEX and corporate confidence are a few examples.

Europe

Ironically, Europe has been most affected by the US-China trade spat given its dependency on global trade and CAPEX, both of which have fallen. Car exports alone account for 5% of German GDP. European equities gained 1.52% over the quarter but with a notable disparity between sectors. Similar to the US, cyclicals performed well, namely tech (9.2%), consumer discretionary (7.6%) and industrials (8.1%) but sectors related to the trade war exposed areas of the market performed less well. On a forward P/E metric, European equities remain undervalued trading at 14.4X compared to a broader average of 14.6X, according to JP Morgan.

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Whether Europe is next on Donald Trump's 'hit list' for tariffs is yet to be seen. The EU currently charges 10% on car imports from the US compared to a 2.5% tariff on EU car imports to the US. However, despite hostile comments about Europe recently, it is China that remains firmly in the President's cross-hairs.

Brexit and the UK

UK equities similarly saw a reasonable quarter, with the FTSE 100 rising 1.48%. Equities remain undervalued with a Brexit discount priced into markets and have been trading at a forward P/E of roughly 12X compared to its historic average of 14X. The more defensive areas of the UK performed best, those with diversified product lines, high switching costs and staple products. Brexit remains the greatest hurdle to UK markets as the persistent uncertainty in the outcome caused CAPEX to stagnate. Manufacturing PMIs in the UK fell 1.4 points to 48 as the effect of stockpiling during Q1 continues to weigh on sentiment. For reference, PMI is a proxy for business sentiment. A PMI of 50 indicates sentiment is unchanged, greater than 50 is an improvement and less than 50 shows a deterioration. The fall in sentiment has had its most noticeable effects on the more domestic facing companies in the UK.

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Brexit continues to rock Sterling which reached a peak for the year to date of $1.33:£1 on the 13th March but has since depreciated and was trading at 1.25 against the USD at the time of writing. Depreciation acts as a tailwind for earnings of multinational companies repatriating their incomes from overseas yet whether this translates to a higher valuation will depend on investors' views of our current market cycle.

The threat of a general election is having muted effects in the UK market at present. Should Jeremy Corbyn win, his current stance on policy of increased government spending may see a sell off in bonds and the FTSE 100. His proposed renationalisation of utilities including SSE & National Grid has caused higher volatility in their stocks over the quarter.

Gold has enjoyed a strong rally over the quarter and year-to-date returning 7.5% and 10.46% respectively, in dollar terms.

The UK yield curve remains upwards sloping as it is positioned earlier in the market cycle and has incorporated the inflationary effects from the depreciation of the sterling. The 10-year gilt is yielding 1.33% compared to 0.52% on the 2-year gilt. Yields of all maturities have fallen over the year, reflecting a cautious sentiment on holding risk assets.

Commodities

Gold enjoyed a strong rally over the quarter and year-to-date returning 7.5% and 10.46% respectively, in dollar terms. The gold price recently traded at its highest price since 2013, priced at $1,404 at the time of writing. This move was fuelled by expectations of the Fed cutting rates—reducing the opportunity cost of holding gold—and the flight to safety trade as investors became cautious on the market outlook.

Conclusion

Whilst investors judge whether markets are in-fact mid or late cycle, there are evidently obstacles that need to be overcome for the market to continue rising. Whilst equity valuations are looking reasonable, more so than bonds, the fundamentals look weak. Corporate confidence and CAPEX have been damaged by the political environment and as such are feeding through to the bottom line. With a lack of CAPEX the ability to grow revenues is hindered. Whilst the bond market reflects investor pessimism, should the political landscape start to improve and subsequently restore corporate confidence this could prove to be a tailwind for markets, feeding through to earnings and subsequently valuations. But given the wide array of political headwinds and to the difficulty of predicting Trump's next tweet, there is evidently a large disparity amongst investor sentiment.

In summary, risk assets should continue to be supported by a stabilisation in global growth, albeit at lower levels.

Equities historically perform best in the late cycle, so the timing of any rotation is important. Whilst the focus is now on earnings releases, trade related news, Brexit and China—improvements in any of them should provide a tailwind for the markets. With expectations of a Fed interest rate cut, the ECB contemplating extra stimulus, China increasing its fiscal policy package to over 2% of GDP, and subdued inflationary pressures in the EM providing headroom for further easing, even this combination may not be enough to restore corporate confidence and CAPEX. For this, a combination of easing policy and political stability may be the solution.

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