Stanhope Capital

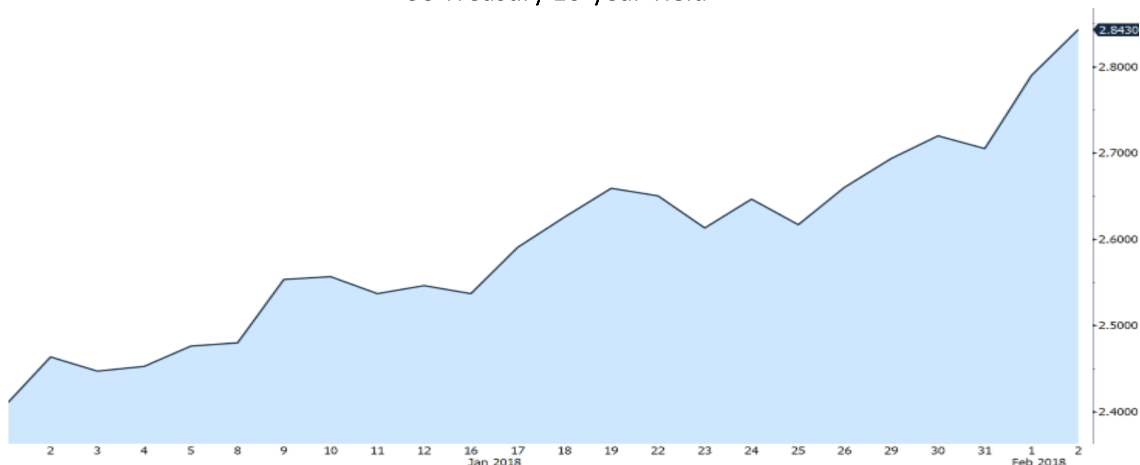
Stanhope Capital Fortnightly Bulletin

Period ending 31st January

Tactical Positioning

In our Bulletin dated 15th January, we pointed out that the yield on the 10-year Treasury bond was used to price assets around the world and that an unexpected 'lurch' upwards in the yield could be taken badly by markets. At that time the yield was 2.54% and as of the end of January it is 2.70%. This level was last seen in March 2014, from which point the yield then reversed and fell to 1.65% in the space of 8 months as markets dismissed the idea that inflation was seeping into the economy. This time, the strength of the U.S economy (particularly the labour market and recent tax cuts) make the prospect of a rise in inflation more likely. For investors, the main question is whether this is a surprise. The answer is probably not. In fact, the real surprise could be that it has taken 10 years for inflation to get back to normal, healthy levels (2% inflation is a favourite target for Developed Market economies). It seems to us that we are currently experiencing an adjustment to a more uniform, broader, global economic recovery. This may cause some short-term indigestion and a rise in volatility, but we have yet to see whether it causes inflation to rise to anything more than 'normal' levels.

US Treasury 10-year Yield



Source: Bloomberg

One asset class that can benefit from a pick-up in volatility is convertibles. These are 'hybrid' instruments with part equity and part bond characteristics. Like bonds, they redeem at a fixed price in the future but they also offer conversion rights into the ordinary shares of the issuer at a future date. A pick-up in equity volatility gives greater value to the conversion rights and so they could benefit from current market conditions. We are looking to add a specialist convertible fund in many portfolios.

Market Moves

	Equities *(Local Currency, incl. Dividends)*						
31-Jan-18	**World**	**US**	**Europe[1]**	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	0.5%	1.4%	-0.7%	-3.0%	-2.6%	3.1%	2.3%
YTD	4.1%	5.7%	2.3%	-2.0%	1.3%	6.8%	5.5%

	Commodities			Currencies *(vs. USD)*			Gov't
	BCOM	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y[2]**
Last 2 Weeks	1.3%	0.4%	0.7%	1.2%	2.9%	1.2%	+16 bps
YTD	2.0%	3.2%	7.1%	3.4%	5.0%	3.2%	+26 bps

1. Europe excluding UK 2. US Treasury 10 year yield shows absolute, not percentage, change in yield Source: Bloomberg

Rising inflation expectations proved more influential on markets than the Federal Reserve's hawkish stance, causing the dollar to weaken versus the euro, yen and sterling which, in turn, translated into weaker equity market performance in the eurozone, the UK and Japan. Conversely, the dollar weakness supported a continued rise in Asian and Emerging Markets. Oil, which is traditionally negatively correlated with the dollar, rose almost 1% bringing its increase to 7% so far this year, with the West Texas Intermediate crude price trading above $65 per barrel for the first time since 2014. Gold and commodities rose marginally over the period, once again symptomatic of a weaker dollar and rising inflation expectations.

Economic Updates

Indicators in the US released over the period continued to demonstrate strong economic momentum. The Dallas Fed Manufacturing Index came in at 33.4 for January, well above December's reading of 29.7, marking a 12-year high, with expectations of future general business rising to 44.5, the highest reading since 2004. Similarly, the January Conference Board Consumer Confidence Index was 125.4, above market expectations of 123.0 and only slightly lower than November's 17-year-high of 129.5.

Also, in the US, the ISM Manufacturing Index for December fell modestly to 59.1 from 59.3 in November, representing a slight cooling off from the ultra-high levels last year but nevertheless demonstrating healthy expansion.

In the Eurozone, fourth quarter GDP growth was in line with expectations at 0.6% and the final reading for the European Commission Consumer Confidence Indicator was confirmed at 1.3, marking a 17 year high. The composite PMI was above market expectations at 58.6 versus forecasts of 57.9 (this is broadly consistent with quarterly GDP growth for the first quarter of around 1%!).

Elsewhere, China's manufacturing PMI index for January was marginally below expectations at 51.3 versus 51.6 expected. Given that the index focuses mainly on larger businesses and state-owned enterprises, we could see further softening this year given the government's crackdown on corporate debt and pollution. However, growth in the services sector picked up with the non-manufacturing PMI rising to 55.3 from 55.0 in December.

JONATHAN BELL
IVO COULSON
IMOGEN HERVEY-BATHURST
31st January 2018

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