Stanhope Capital Fortnightly Bulletin

Period ending 31 May 2018

Tactical Positioning

Over the last two weeks we have been watching the energy market closely. During the past 12 months, oil has risen by close to 40%, culminating in a 'mini-spike' in recent weeks. Although there has been a near term price pull-back, the fundamentals behind oil and energy demand seem to have moved to a more bullish footing. Global demand has picked up at a time when supply has fallen and news of the re-imposition of U.S sanctions against Iran and a collapse in supply from Venezuela seems to have put a new, higher, floor under oil prices. We think a price of $70 per barrel (for West Texas Intermediate, WTI) is a distinct possibility against an average of $56 over the last 12 months. Oil equities have significant operational gearing to a higher oil price, yet the sector has lagged the rise in oil by around 20% over the last 12 months. We believe that, if oil prices remain at these levels, there will be a catch up in energy stocks and, looking ahead, significant earnings upgrades for energy companies accompanied by dividend increases and share buy-backs. With this in mind, we have added an energy equity tracker across many portfolios.

Market Moves

	Equities *(Local Currency, incl. Dividends)*						
31-May-18	**World**	**US**	**Europe**[1]	**UK**	**Japan**	**GEM**	**Asia**
Last 2 Weeks	-1.2%	-0.1%	-3.5%	-0.4%	-3.2%	-2.2%	-1.3%
Year to Date	0.8%	1.8%	-0.9%	1.9%	-3.1%	-0.4%	0.9%

	Commodities			Currencies *(vs. USD)*			Gov't
	BCOM	**Gold**	**WTI Oil**	**EUR**	**GBP**	**JPY**	**UST 10Y**[2]
Last 2 Weeks	0.7%	0.6%	-6.0%	-1.2%	-1.5%	1.4%	-21 bps
Year to Date	3.6%	-0.3%	11.0%	-2.6%	-1.6%	3.6%	+45 bps

[1] *Europe excluding UK*

[2] *US Treasury 10 Year Yield shows absolute, not percentage, change in yield*

Source: Bloomberg

Equity markets generally lost ground over the fortnight as investors digested the extraordinary sequence of events which beset Italian politics. More than two months of intense negotiations between the populists of the Five Star Movement and Northern League culminated in a coalition agreement and leaked papers suggested a radical plan to ask the European Central Bank to write off €250 billion of Italian debt and a mechanism to move away from the single currency. President Mattarella's decision to block the populist coalition's preferred nominee as Finance Minister sent further shock waves through markets. The collapse of the coalition before it managed to form a government and Mattarella's nomination of an ex IMF director as Prime Minister of a technocratic government, raised the likelihood of new elections and a chance that populist, anti-EU parties, might see their support dramatically swell. At the end of the month, the situation pivoted again, with the news that the deadlock had been broken and a populist government under the leadership of Giuseppe Conte was on track to be sworn in.

The impact on Italian government bonds and wider markets was significant. 2-year BTPs, in negative yield territory until May 8th, surged to an intra-day high of 2.76% in the aftermath of Mattarella's intervention, before settling back down to 0.91%. Strikingly, in the G7, there has only been one day in the past few decades with a +/- 100 basis point move in 2-year government bonds. European equities and in particular financials, fell sharply in the face of the political uncertainty, with investors clearly apprehensive about the number of banks with Italian sovereign debt holdings representing over 100% of their Tier 1 Capital. Elsewhere, the yield on 10 year US Treasuries, Gilts and Bunds fell.

Not content to let Italy steal the limelight, the US announced that it will impose tariffs on steel (25%) and aluminium (10%) imports from Canada, Mexico and the EU. Unsurprisingly this move prompted swift retaliatory measures from its three allies and the increasingly protectionist environment saw equity markets fall further.

Turning to the Far East, a joint announcement between the US and China, appeared to show signs that China is making positive steps down the path to reducing its trade surplus. It remains to be seen, however, whether the issue surrounding the theft of US intellectual property by Chinese companies, which has so vexed the Trump administration, can be overcome. The much-anticipated meeting on 12th June in Singapore between President Trump and Kim Jong-Un remains in the balance. President Trump cancelled the meeting citing *"open hostility"* from the North Korean regime, before talks between US Secretary of State, Mike Pompeo, and a senior North Korean official in New York led to the summit being reinstated.

The negative macro headwinds, outlined above, strengthened the US dollar against most currencies. Within developing markets, the Turkish lira fell to an all-time low against the US dollar, as Fitch Ratings pointed to a possible credit downgrade for Turkey given the continued erosion of the central bank's monetary policy independence. The collapse of the lira partly reversed as President Erdogan, in the face of intense pressure, begrudgingly allowed the central bank to raise rates from 13.5% to 16.5%. His unorthodox belief in tackling inflation by lowering interest rates sets him apart from almost every economist. Another newsworthy development over the fortnight took place in energy markets. The price of crude oil initially climbed to $72 per barrel (WTI) and then dropped sharply amidst rumours that OPEC may start phasing out their supply curbs due to concerns about diminishing Venezuelan and Iranian output.

Economic Updates

In the US, economic data was robust, as highlighted by industrial production for April which rose by 0.7% month-on-month, its third consecutive monthly increase. The overall Philadelphia Fed Report was very strong and came in at 34.4 vs. 21.0 expected, the record since June 2017. At a more granular level, the "prices received" component of the report reached its highest level in 29 years and follows similar readings across other regional and national surveys which suggest more evidence of pricing pressure. The wages component of the Richmond Fed Manufacturing Index, for example, came in at its highest level since 1997, whilst the "prices paid" component was the highest in six years. Furthermore, the Kansas City Fed Manufacturing Index came in at 29.0 vs 20.0 expected, a new record high.

Economic data on this side of the Atlantic was broadly mixed. In the Eurozone, the composite Purchasing Manufacturing Index (PMI) came in at 54.1 vs. 54.6, the lowest reading in 18 months, partly the product of softening external demand. Eurozone CPI was impacted by rising oil prices and rose 1.9% year-on-year vs. 1.6% expected. In Germany, first quarter exports fell 1.0% quarter-on-quarter, the biggest decline since the end of 2012 and the latest composite PMI reading came in at 53.1 vs. 54.6. On the other hand, unemployment fell to a fresh low of 5.2% vs. 5.3% expected and there was a 2.3% month-on-month increase in retail sales, which follows four consecutive monthly falls. It is noteworthy that inflation in Germany marked its highest reading since April 2012, at 2.2% year-on-year vs. 1.8% expected. There are growing fears that German bond yields are increasingly detached from economic fundamentals, with the gap between German inflation and 10-year Bunds within a fraction of record high levels. The inflationary picture was different in the UK, with core CPI at a 13-month low of 2.1% year-on-year vs. 2.2% expected.

Japan's economy contracted for the first time since 2015, with the preliminary reading showing GDP falling by 0.6% year-on-year vs. an expected fall of 0.2%. This was the weakest nominal GDP growth since 2012. The Governor of the Bank of Japan, Haruhiko Kuroda, consequently maintained his dovish tone and emphasised the need to "patiently pursue powerful monetary easing to achieve 2% inflation".

JONATHAN BELL
IVO COULSON
HARRY COOKE
31 May 2018

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