ATP QUARTERLY: ASSET ALLOCATION UPDATE

AUG. 2018 HALF MAST

ARIA CAPITAL MANAGEMENT

*INTENDED FOR PROFESSIONAL INTERMEDIARIES

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ASSET ALLOCATION HIGHLIGHTS:

- Uncertainty about trade wars represents a risk to the global economic outlook beyond the direct impact of tariffs.
- Profit growth in the U.S. has remained much stronger for longer than many expected, although it does seem to be principally a US phenomenon.
- In fact, removing US markets from international stock market performance, shows most markets heavily struggling YTD.
- The geopolitical environment is ugly, ranging from a shambolic Brexit process to rising populist pressures in Europe, a flaring in U.S./Iran tensions and possible disappointment with North Korea negotiations.
- Rising inflation will force the Fed to engineer an increase in real interest rates, even in the face of slower GDP growth.
- Trade wars are being played out in the currency markets, and ultimately a strong US Dollar will inflict damage upon the US.
- We should retain a beady eye on EM currency crises, often a canary in the coal mine for more general difficulties in asset markets.

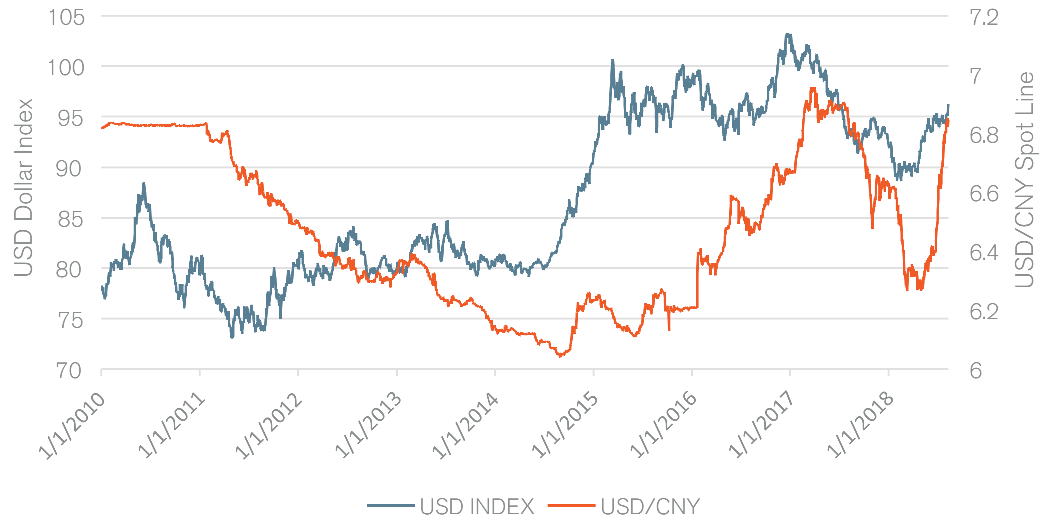
FLAGS AT HALF MAST AS WE PREPARE FOR EQUITY MARKET VOLATILITY ONCE MORE

It's difficult not to start this quarterly update and sidestep trade tariff tensions. So we'll not – we'll draw upon a facile idiom, and contend that the US and China, as the principal protagonists of this ongoing saga, are two sides of the same coin.

At least in terms of the global monetary order that is – at least from an FX market perspective. Whilst Beijing's way is to operate in a very planned and prescriptive manner, it is planned to the extent it is following in the footsteps of the Singaporeans, in creating a basket currency which meets the local trading requirements, whilst internationally mimics the US Dollar in many ways.

The Renminibi reflects the Chinese Politbureau's conception of what the global value of the Dollar should be – until now though, it is still not trusted in the way in which Uncle Sam's greenback as a medium of global exchange is. Donald Trump exhorts that internationally countries exploit the US to their own ends, as evidenced by trade deficits. However, the US Dollar's hegemony as the pre-eminent global currency has provided an unfair (underpriced) cost of capital for the US to drive higher its own living standards... for decades. Of course, the 'trust' in the US Dollar's dominion, and currency of global trade could ultimately be eroded by the President's antics. Perhaps the real 'trade wars' are being played out in the currency markets.

CHART 1: US DOLLAR PERFORMANCE VERSUS ITS CHINESE COUNTERPART

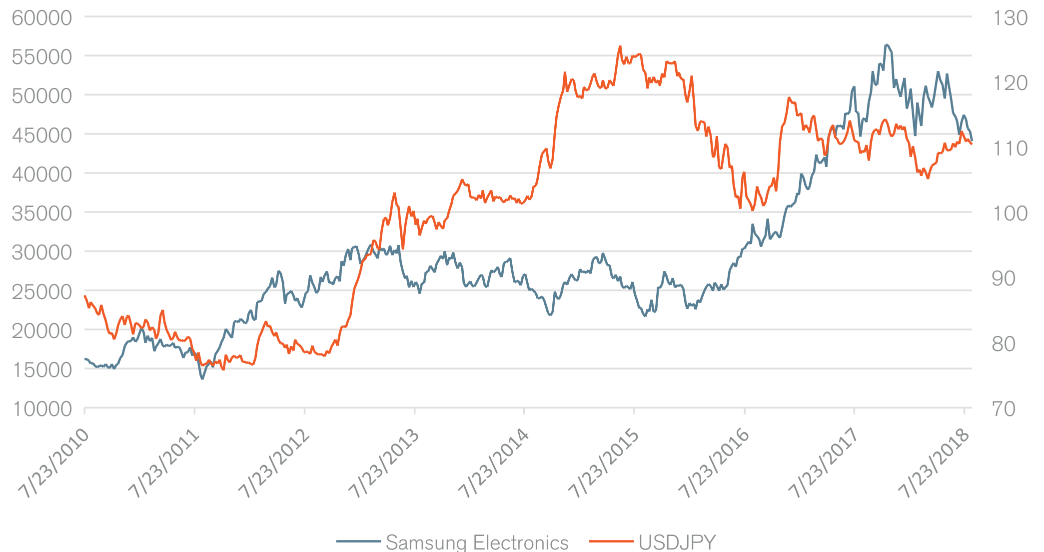


SOURCE: ARIA, BLOOMBERG

MERCANTILIST MANOEVRUES

However, it is not just China that suffers at the hands of the trade wars. Both Europe and Japan have also been cited by the White House as offenders. Chart 2 shows that beyond the US Dollar / Renminbi relationship, the Japanese Yen is also making significant moves. Continuation of recent weakness against the US Dollar in these past few weeks would suggest the Yen will weaken for the foreseeable future as the US Dollar bull market continues unabated. We believe that this up move was a function of the tariff battle that Trump and Navarro had started against the Chinese and by default against all the other mercantilist Asian nations

CHART 2: RECENT YEN WEAKNESS HAS NOT BEEN ENOUGH TO SUPPORT JAPANESE EXPORT STOCK PERFORMANCE



SOURCE: ARIA, BLOOMBERG

It's an understandable and natural response of any government caught in the line of trade war fire to weaken their currency, to soften the blow domestically. Whether the hand of government is at large here, or simply the market is drawing the correct conclusions, the natural corollary of a trade war is for Asian currencies to weaken. Once more, we should view the implications of trade wars as having mirror image or two-sided consequences. Whilst we should expect an inflationary impact for the US, it will be a deflationary force for Asian exporting economies. As their currencies weaken, their goods become cheaper to a) offset some of the impact of the tariffs on their prices and b) support demand for their goods at a time of weakening global trade numbers. Ultimately, the overall net effect is deflationary.

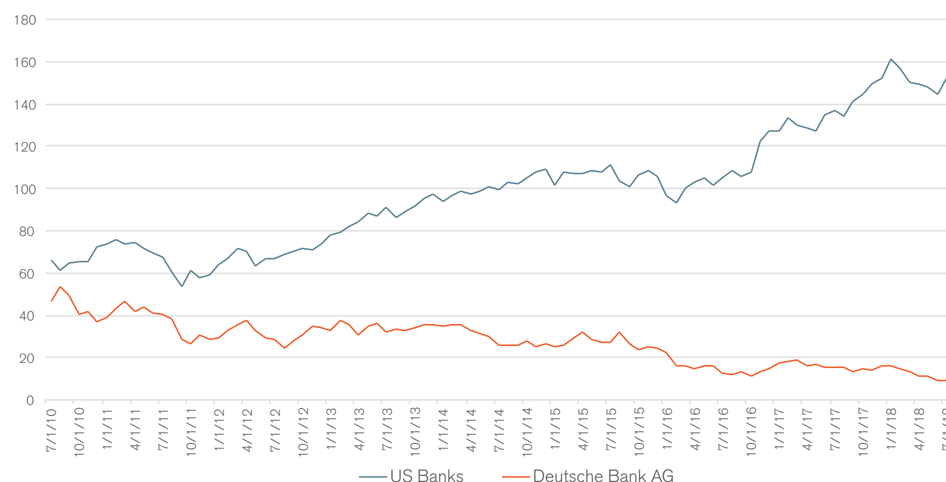
Many economies will import less as goods are more expensive. This deflationary outcome may go some way to explaining why precious metals have weakened dramatically in recent weeks, even at a time of heightened political uncertainty and emerging market currency crises, which might ordinarily see gold rise as a safe port in a storm. Donald has already tried to talk the price of the US Dollar down. On balance, most mercantilist countries would (even if not admitted to publicly), prefer a weaker currency than a stronger one. Tariffs may be an effective tool of taming the Chinese tiger in the short term, but not if it leads to a conflict that ultimately brings down the global trade structure. In such a case, nobody wins, as the 1930's and the history of tariff barriers tell. At a time when the US is removing stimulus, and increasing interest rates – read reducing the amount of US Dollars in circulation, tariffs provide a further tailwind for the US Dollar. It might ultimately be the strength of Donald's own currency that causes him to soften the rhetoric, (with mid-term elections on the horizon too), rather than having to bow to the political will of other countries.

DONALD vs JEROME

Whilst 'trade wars' have continued to dominate the front pages, Jerome Powerll and his policy normalisation initiatives, or telegraphed interest rate increases, have receded the media shadows. Rest assured though, a determined path of interest rate hikes remains just as important an influence for the prospects for financial markets, as trading a trade war does. There has been a distinct change of regime at the US Federal Reserve, where Bernanke and Yellen could always be relied upon to take a dovish turn. Super Mario, being Mario Draghi of the European Central Bank, has taken up the dove's baton. During the quarter, the ECB provided greater detail on their planned exit from stimulus programs – or their asset purchase program. The ECB was already some way behind the US in normalising policy, and the market interpreted the information given, as suggesting the ECB was even more reticent to rein in stimulus and move European interest rates above the waterline, than expected. That led to severe weakness on the part of the Euro - although hardly unwelcome from Mario Draghi's perspective - anything that supports European manufacturing, export growth and eases the deflationary tide the continent still labours under, is warmly received.

Unfortunately, to our minds, this does little more than perpetuate the major valuation anomalies that punctuate European asset markets. European credit assets, corporate and government bonds are still significantly mis-priced, or too rich given the unrealistically lower level of interest rates. In other respects, it does nothing to support the lifeblood of the European economy – its banking system. Deutsche Bank is the most notable casualty, but across the board the euro banks have suffered terribly when compared to their US brethren. The underperformance of the European stock markets compared to the US is readily understood when known that they are overweight banks and financials and lacking in technology exposure which has delivered such superior growth and profit margins to the US bourses.

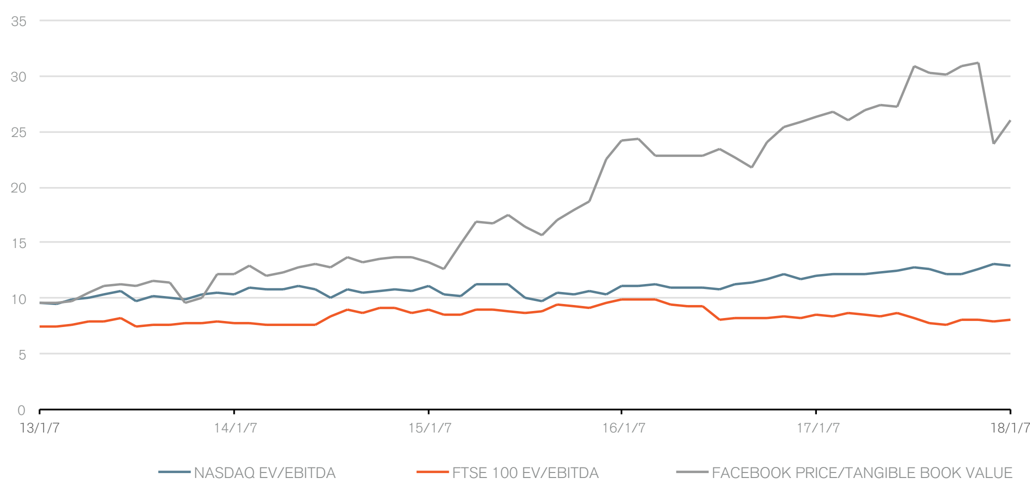
CHART 3: US BANKING PERFORMANCE POWERS AHEAD OF THAT OF EUROPEAN FINANCIAL INSTITUTIONS



SOURCE: ARIA, BLOOMBERG

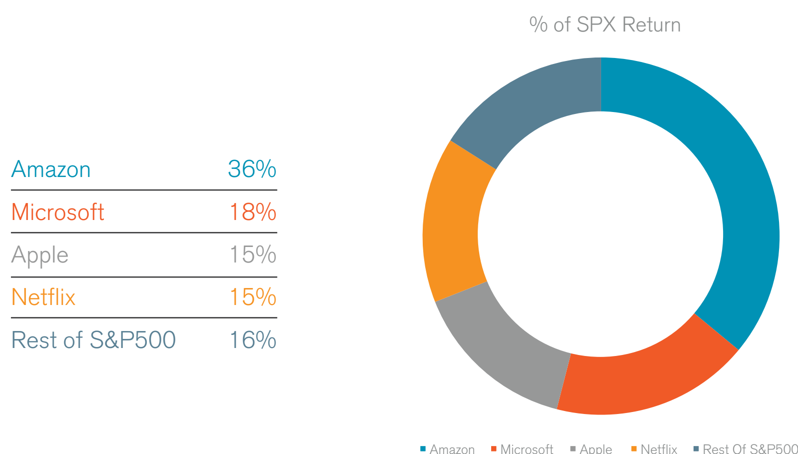
Whilst we do not take issue with the outperformance of the US technology sector to date, share prices in this sector likely need to pause for breath. To date, earnings have kept pace with share prices, but there does appear good reason to curb one's enthusiasm for a while. Valuations are elevated – almost priced for perfection. Witness the reaction of Facebook's share price after this quarter's earnings were release – a 22% fall, for only having narrowly missed expectations. That equated to a loss of nearly 115bn USD in a matter of hours of trading. So even adjusted for robust cash flows and profit margins, the NASDAQ trades at 13.4 estimated EV/EBITDA which isn't cheap by any stretch of anybody's imagination. Moreover, if we remove Apple from the reckoning, there has been a material increase in leverage in the balance sheets of many of these tech titans. We have discussed Netflix's thirst for debt previously, necessary to finance a rapacious appetite for new content. That leads to a divergence between book value and 'tangible book value' – assets such as goodwill on the balance sheet which are more difficult to value and susceptible to mark down pen of an auditor. Of course, the wrath of the regulator and its propensity to fine the many tentacled tech companies as they are perceived, is another risk to earnings.

CHART 4: THE NASDAQ INDEX IS TWICE AS EXPENSIVE AS THE FTSE 100 BY SOME VALUATION METRICS



One of the reasons we are currently in the process of lowering the equity flag to half mast (or lower) position, is on account of the likely stumble in technology shares going forwards. Tech has been an isolated outpost of growth in financial markets, remove their influence on indices and many stock markets year to date are not faring well at all. The following graphic really does go to show how important the tech giants are in supporting the fortunes of the US markets:

CHART 5: US MARKET STOCK MARKET PERFORMANCE HEAVILY DEPENDENT ON FOUR TECHNOLOGY STOCKS'



SOURCE: ARIA, BLOOMBERG

Finally, it's clear that technology is an 'overweight' position for all grades of investor – both institutional and retail. The share prices of the FANGS and others are overextended, and as interest rates rise, and the cost of capital increases, tech companies with higher debt burdens than they have had in previous years are susceptible to disappointing, given heightened earnings expectations. Over the long run, even a correction in the realm of 20% would likely be a healthy pause and provide an attractive entry point once more.

EUROPEAN VULNERABILITY

Perhaps underappreciated is Europe's vulnerability to trade tensions. German and French industrial production data has slumped and the growth data momentum has decelerated, even when US economic data continues to hold firm. We expect that European earnings estimates are still far too optimistic given that sectors of primary importance being cyclicals, engineering industries and the banks are much more exposed to emerging markets than would be commonly recognised. For instance, French supermarket chain Carrefour derives 17% of global sales from Brazil alone. Unfortunately, not only does Unicredit has to operate in a stagnant Italian economy, it also owns a strategic stake in the Turkish Yapi Kredit Bank. The Spanish bank Santander and BBVA have huge listed subsidiaries in Brazil and Argentina.

Glencore, Anglo-America and Barclays have significant exposure to South Africa. The weakness in the Euro relative to the US Dollar is not sufficient to offset the burden that the dearth of tech names, Brexit fears, the faded synchronised global growth narrative of 2017 and finally the threat of 25% tariffs on European auto imports by Trump means. The European auto industry is a celebrated example of the tightly integrated global supply chain and damage caused by the tariff wars waged by Trump in order to speak to his 'base' is notable. BMW sells 10% of global vehicles to the US and Daimler similarly – Daimler is also exposed in its US truck business which faces higher steel and aluminium prices. Stand clear of European equities for now.

SUBMERGING MARKETS

Eighty percent of EM foreign currency debt is denominated in US Dollars. A Federal Reserve in tightening mode has already sent shockwaves through emerging markets. What has already transpired is a feedback loop whereby EM borrowers are unable to repay back their debt, capital leaves emerging markets and further strengthens the US Dollar. As we have already seen, this forces the central banks of emerging markets to respond, raising rates to protect their currencies. Higher rates just imperil local borrowers furthermore and for politicians as in the case of Turkey's Erdogan, forces a political response, such as the one whereby he has appointed himself as the heavy handed, de facto monetary policy executive and also declared himself to be the as the 'enemy of interest rates'. It will be difficult to win that particular duel with a sky-high inflation rate of 12%.

During the last EM tumult in 2015, China rode to the rescue launching a sizeable stimulus program. Fiscal spending and credit growth lit a fire under industrial commodities and cyclical assets, including emerging markets. recently Beijing provided some respite, as the State Council outlined a package of measures to ease the burden of a trade war related economic slowdown. However, we don't see this as indicative of the return of the 'Beijing put'. The bar is higher this time round. With elevated debt levels, excess capacity in some parts of the industrial sector, falling property prices in Tier1 cities, dampening fixed asset investments and industrial production falling, the instinctive recourse to infrastructure spending will need to be of sufficient ballast to stem the prevailing tides. We sense that the purge on corruption is indicative of the times – Beijing is looking to curb excess rather than reignite it. Any policy response is likely to be seen in the currency markets. On the last occasion when China devalued the Renminbi it led to a massive capital flight. As we stand, nearly three years on, capital controls are much tighter meaning that would be less likely to come to pass in the event of a currency devaluation. Whilst China cannot win a toe-to-toe trade war with the US, given that it exports vastly more to the US, than the US does in return, China could (and likely is) waging war in the currency markets. It could step up its purchases of US Treasuries, giving a further tailwind to the US Dollar, and increasingly make life more uncomfortable for the us President.

ASSET ALLOCATION OUTLOOK:

Fund	Asset Class	Sector	Commentary
Global Equity Absolute Return	**Global Equities**	Developed Markets	- Principally long bias in the Fund until recently. - As time has moved on, higher debt burdens in certain growth stocks have led to deteriorating fundamentals in many tech names, hence appearing as poorer quality shares and potential short candidates. - During bull markets, as shorts see share price falls, we must remain quick to take profits and close out positions. - As and when that happens, the Fund recycles into new 'poorer quality' company shorts.
Alternative Income	**Fixed Income**	Government Bonds European Bonds	- Global rates have turned, and the cycles argue for a move higher, having softened a bit to reflect slower growth in the short term. - Our view is that growth issues will cap any significant move higher in global interest rates and government bonds generally. - End of QE does not mark the end of very loose policy. In fact, Draghi remains dovish. - First hike might not be until September 2019 – eons in our world and a lot can / will change. - Much weaker euro in the weeks ahead/ receive European interest rates, including Gilts.
Global Dividend Value Plus	**Global Equities**	Global Value Shares Income Strategy	- If we look at the MSCI World indexes that include either Momentum or Value stocks, the past few months have seen the gap widen significantly. - At the end of June, Momentum was within 1% of an all-time high, while Value has slipped more than 7% from its own high. - While there has been a secular preference for momentum over the decades, it has ramped up lately and the two are increasingly becoming divorced. History shows I think, that is not typical to have momentum doing so well, while value is all but abandoned. - When investors have shifted to one side of the market as much as they have now, intuitively it would usually be about the time for a move to the other side, suggesting value should be more likely to show higher returns in the months ahead. - As volatility rises, we will look to generate higher income still from the put selling strategy.

Fund	Asset Class	Sector	Commentary
Diversified Alternative Assets	**Alternative Asset Classes**	COMMODITIES CURRENCIES EM MARKETS	- Commodities are turning up, but the rally will be brief in our view coinciding with a brief dip in the US Dollar. - The Chinese have put a large amount of liquidity into the market and prices could even rally to mid September. - The industrial metals complex looks particularly weak and will afford shorting opportunities as above. - The Asian currencies have been decimated over the past three months, many of them down more than 4%. - With the PBOC weakening the CNY against the USD a notable change from the deliberate strengthening seen earlier this year. - We expect the Asian commodity currencies, such as the MYR and IDR, to continue to receive the largest bruises. - With a bullish Fed for now and the trade war showing few signs of easing, the USD weakness / EM FX rally will not last too long. - A long position in MSCI China today feels deeply uncomfortable given the headline news flow. - However, intrinsic value is attractive on a range of outright and relative measures – of course, we have just had the 'bear market' headlines. - MSCI China still trades at only 11 times forward earnings.
Global Equity Leaders	**Global medium cap equities**	Global Momentum Equities	-In recent months, it's been very clear at how much more investors are favouring momentum type stocks at the expense of almost anything value-related. (See Nasdaq!) - That has been focused on U.S. shares, which had seen the most extreme preference for momentum. - But even when looking at overseas stocks, which have struggled mightily overall, value has grown increasingly out of favour. - We expect that this divergence will close in due course, therefore, hedging strategies will be important.

CONCLUSION:

There are a number of cross currents in the markets presently, which as their importance begins to dawn on investors, we feel will mean inevitable heightened volatility across asset classes in the coming weeks. At the tail end of already long in the tooth economic expansion, Donald Trump frogmarched over long established prudent macro-economic policy, by cutting taxes and ramping up capital expenditures simultaneously. Fiscally, the US was already in a precarious position, but additionally, we have seen the equivalent of launching a major military offensive in terms of government spend, without raising taxes to finance it. The Federal Reserve is simultaneously withdrawing stimulus from the system, meaning a stronger Dollar, whilst having to increases its auctions for US Dollars to finance the capital expenditures, putting pressure on interest rates to rise, further putting a bid under the US Dollar. Funding the US is not necessarily difficult for the Treasury – it has the advantage of borrowing in the world's solitary global reserve currency, (still), and to most institutional investors remains a copper bottomed creditor. However, it is other US Dollar funded borrowers who feel the pain – emerging markets, high yield and lower credit quality borrowers too. The 1980's perhaps offers a comparable analog – a period when the it rallied from 1.75 to 3.50 Deutschmarks in three years. This will cripple many an emerging market, whilst many Asian mercantilist, export orientated nations will quietly accept it. Ultimately, it will cause as much disquiet to earnings in the US as it has done to emerging markets. Emerging market currency crises have been the starting pistol for many a wider financial market drama.

ARTISTIC DIFFERENCES:

In July, Donald Trump sent a rather blunt message to Jerome Powell – stop raising interest rates. This coincided with a 4.1% US GDP figure underlining the Federal Reserve's Chair's stated intention to continue to raise rates judiciously. As the Federal Reserve now seems next in line to receive the unwanted attentions of the President, it will be interesting to watch the degree to which Chairman Powell acquiesces, and with it, publicly undermines the independence of the Federal Reserve. Unfortunately, a number of Donald Trump's policies are inconsistent – conversationally speaking- something has gotta give. Within portfolios, we have increased hedges in the last few days, and will continue to add protection against an increasingly likely equity market correction. We had suggested earlier in the year, that the best trades of 2018 will be in Q2, most likely after a flush out of sorts. The roadmap therefore remains set fair, save for a change of heart in the Federal Reserve. Until recently, investors were well recompensed for assuming that the Fed would ride to the rescue to prevent any genuine equity market correction developing into a double (or even high single digit) percentage fall. However, now they have to reckon with a Federal Reserve that is looking to temper growth, and if lower asset prices expedite such an outcome, then so be it.

The combination of slower global growth and a resurgent US Dollar is likely to hurt commodity prices. Industrial metals are more vulnerable than oil but are oversold as we stand. China consumes around half of all the copper, nickel, aluminium, zinc, and iron ore produced around the world. In contrast, China represents less than 15% of global oil demand. Given that we remain comforted by the yield offered by energy REITs in the alternative asset allocation of portfolios, but more comfortable still hedging them with short positions in industrial metals into any recovery of their prices. As monetary conditions have tightened in the US, we endeavour to hedge out emerging market stocks by rotating to higher quality companies, and selling weaker indices against them. Finally, we have rotated much of the equity exposure towards high quality and value names within developed markets, whilst simultaneously identifying growth companies (specifically Nasdaq stocks) for shorting opportunities given many of their share prices have likely gotten ahead of themselves.

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