October 2018

Quarterly Commentary

MelvilleDouglas
A Member of Standard Bank Group

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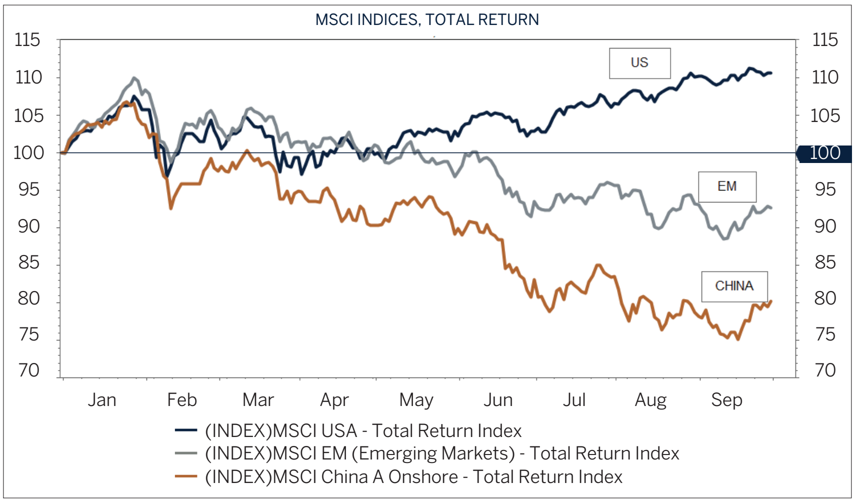
Investment Environment

Asset classes have largely moved in line with changing but positive economic fundamentals this year. Global equities have outperformed fixed interest assets and the US dollar has benefited from increasing interest rate and growth differentials. The divergence in growth between the US and the rest of the world was not expected, and Donald Trump's strategy of "America first" has had a dampening effect on global trade and the value of emerging market assets. Outside the US, the world is struggling with the higher cost of US capital, and the higher costs of doing business imposed by tariffs. The outlook is not expected to change much, but the path will become rougher as global liquidity becomes less supportive, US-China trade tensions escalate and the political backdrop in Europe stays uncertain.

Trade war

Global trade continues to make headlines. The US imposed tariffs on another $200 billion of imports from China on 24 September. Up to now, investment markets have largely shrugged off the news as the initial tariff of 10% was less than expected. If no progress is made, tariffs on Chinese imports will rise from 10% to 25% on 1 January 2019. Furthermore, the Trump administration has threatened to follow up with a third round of tariffs on remaining imports from China. The Chinese immediately retaliated with tariffs on $60 billion of US imports and showed no sign of backing off. The response from China is not surprising, but the end result of these escalations will certainly be much more damaging for the Chinese economy should some form of compromise not be achieved, which at this point looks unlikely. But it is not just China's economy which will be affected. The whole supply chain, including many emerging Asian economies will also be influenced. Investors have been voting with their feet, as illustrated by the significant outperformance of US equities over China and emerging markets equity indices.

EQUITY MARKETS 2018



Source: FactSet

China does however have other options to consider other than trade tariffs. Certain US companies with operations in China such as GM and Apple sell more of their products in China than the US, and Chinese authorities could introduce certain measures or regulations which could be damaging for US subsidiaries operating in China in the long run.

Although the overall impact is somewhat uncertain – much supply will be derived from markets where tariffs do not apply – tariffs are nevertheless an additional cost to businesses. The effect is negative in the short run as companies will defer investment spending, but certain economies could benefit as importers in the US and China would switch to alternative suppliers.

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US companies in the meantime will have to decide whether to pass on the higher import prices or absorb the increased costs. The first option will result in inflationary pressures for the Federal Reserve to contend with and the latter option in lower profit margins and a slowdown in earnings growth. Both options are headwinds for US equity investors and perhaps the US dollar.

The threat of escalating trade tensions alongside a more restrictive US monetary policy and fading fiscal stimulus will act as additional risks to the global economy, which is already understandably showing signs of a slowdown in growth momentum.

Quarterly Commentary

Italy

Italy's debt at 132% of GDP has for some time been a headache for the European Commission (EC), as the sheer size of outstanding government debt makes Italy too big to bail out and makes the economy very vulnerable to any cyclical or external shocks. Past governments have been able to keep a tight rein on finances, but it has been exactly these restrictive measures and structural reforms that have opened the door to a populist coalition government.

The new government made many promises leading up to the elections earlier this year, which include lower taxes and increased government spending in an effort to stimulate economic growth. Although this may deliver some short term relief, structural reforms such as improved labour productivity are required to get the economy on a more sustainable long-term growth path.

The budget deficit target of 2.4% of GDP was higher than previously promised by the government and much higher than the EC would have wanted (although still below the 3% Maastricht requirement) and higher than the recommendation made by the Minister of Economy and Finance, of 1.6% of GDP. Investment markets reacted negatively: Italian equity prices fell sharply and bond yields jumped again.

Italy's government debt position, without growth, is unsustainable. Borrowing more without simultaneously doing anything to correct the growth problem is guaranteed to make the situation worse. The backstop that is the European Union (EU) will not prevent that, and markets will be doubtful of the EU's willingness to do anything different than it did in the case of Greece – which is a much smaller problem. Italy cannot have a currency devaluation to help it through, so it is caught between the shambles that is BREXIT, which has been an object lesson for potential leavers, and the necessary domestic price adjustment that Greece continues to endure. As Italy's cost of financing rises, and the government continues to ignore the needed reforms, a disruptive outcome becomes a rising risk. The EC is very likely to push back in October and the risk of a sovereign rating downgrade has just increased. Italy is now the ECB's point of vulnerability, capping its ability to allow interest rates to rise, given the exposure of the Eurozone's banking system to Italian government debt.

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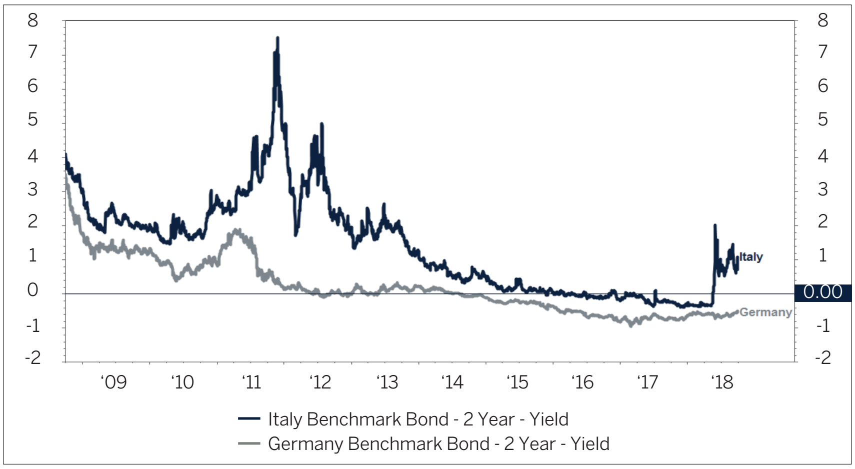
EUROZONE 2-YEAR YIELDS: ITALY AND GERMANY



Source: FactSet

Quarterly Commentary

BREXIT

It is now more than two years since the United Kingdom European Union membership referendum was held in June 2016. There are only six months remaining before the UK officially leaves the European Union in March 2019. The outcome of the eventual "divorce" remains uncertain and will continue to weigh on business confidence and economic activity until the terms are known. Like most divorce settlements, there will be a cost and no one party really wins. In time, both the UK and the EU will establish relationships with and access to new trading partners, but in the short term it will be complicated if free movement of goods and people between the UK and EU is restricted. There is no certainty as yet that a deal will be done. It has been suggested by the EU that November is the latest that a deal could be finalised. This will be a month after the EU summit in October, which is expected to outline the terms of the withdrawal agreement. If a deal is concluded, MPs will then be asked to vote for or against the agreement. In other words, the next few months will be critical for the process of establishing and approving a BREXIT deal. Various sticking points are significant, such as keeping the Irish border open between Northern Ireland and the Republic of Ireland. At present, it is hard to read the final outcome. Whether markets fully reflect the impact and probability of a "no deal" outcome is impossible to say, but the risk remains material and significant price adjustments (currency, interest rates) may be needed to cushion the shock and rebalance capital and goods flows. Time is short.

> "Whether markets fully reflect the impact and probability of a "no deal" outcome is impossible to say, but the risk remains material."

Summary

The US economy has been the leader of a strong global economy this year, but also the cause of volatility and unpleasant adjustments elsewhere as the impacts of tariffs, trade renegotiations and sanctions start to bite. For the US, the growth outlook for next year is less certain. The benefits from lower taxes will begin to fade as we enter 2019, and the Federal Reserve will continue to increase the policy interest rate. For now, this process remains one of deceleration - foot off the accelerator; whether an inflationary surge will force it into full braking mode is a rising but still remote risk. US companies will also have to deal with the implications of a trade war with China as well as a higher oil price. Earnings growth will certainly slow. Other risks are also material; BREXIT looms and Italy will have to find a solution to its debt problems. Prices have adjusted, but not so much as to discount extreme outcomes.

We have learned over time that it does not pay to bet on political and macro events as the eventual outcomes are at best difficult to predict. Our preferred strategy is to focus on fundamentals where the upward progression of corporate earnings along with an extension of this business cycle leads us to continue to support equities over other asset classes, whilst ensuring that portfolios are well diversified.

Quarterly Commentary

Investment Performance

Global economic expansion remains on track, despite there being no end in sight to the US/China trade war and Emerging Market pressures as a result of tightening USD monetary conditions. Global equities continued to advance, outperforming both cash and global fixed income during the quarter. USD strength continued to temper Global USD multi-asset client portfolio returns whilst benefiting GBP Global mandates. Domestic GBP portfolios struggled against the backdrop of a weaker, Technology light, FTSE100 index. Our equity stock selection process has again added value, especially within our Information Technology and Healthcare sector selections. At the asset class level our long held strategic underweight and defensive strategy towards fixed income has protected capital as bond prices eased. In general, portfolio performance continues to please and peer group comparisons highlight very favourable 1,3 and 5 year relative returns.

"USD strength continued to temper Global USD multi-asset client portfolio returns whilst benefiting GBP Global mandates. Domestic GBP portfolios struggled against the backdrop of a weaker, Technology light, FTSE100 index"

Market Performance %

Equities	Q3 2018	YTD	12M
Global			
FTSE All World TR Net (Sterling)	5.53%	7.47%	12.83%
FTSE All World TR Net (US dollar)	4.24%	3.60%	9.67%
UK			
FTSE All-Share TR	-0.82%	0.86%	5.87%
US			
S&P 500 TR	7.71%	10.56%	17.91%
Europe			
Dow Jones Euro STOXX TR	0.57%	0.27%	-0.43%
Fixed Income			
Bloomberg Barclays Series -E **UK Govt 1-10 Yr Bond Index**	-0.39%	-0.67%	-0.08%
Bloomberg Barclays Series -E **US Govt 1-10 Yr Bond Index**	-0.12%	-0.81%	-1.22%
JP Morgan **Global Government Bond (Sterling)**	-0.48%	1.02%	1.19%
JP Morgan **Global Government Bond (US dollar)**	-1.70%	-2.62%	-1.65%
Iboxx **Sterling Corporates** Total Return Index	-0.14%	-1.97%	0.03%
Iboxx **US Dollar Corporates** Total Return Index	0.93%	-2.22%	-1.24%
Currency vs. Sterling			
US Dollar	1.37%	3.70%	2.83%
Euro	0.64%	0.26%	0.95%
Yen	-1.29%	2.76%	1.76%
Currency vs. US dollar			
Euro	-0.56%	-3.22%	-1.65%
Yen	-2.63%	-0.88%	-1.02%

Quarterly Commentary

Asset Classes

Equities	Neutral
Fixed Income	Underweight
Cash Plus	Overweight

- The global economic backdrop remains fundamentally supportive. The strong growth achieved in corporate earnings should not be a surprise to investors given the strong economic backdrop, supportive confidence levels and low unemployment rate. **The US economy continues to support global growth,** which is expected to be above potential output for the balance of the year. Europe should start to catch up as the impact of a stronger EUR and inventory overhang start to fade, while consumer demand continues to provide a favourable underpin.

- Although the reported data remains positive, investors should not become too complacent as the numbers are already history. The risks to the global trading environment and uncertainties that accompany increased protectionism and nationalism remain. BREXIT still needs to play out and Italy's commitment to fiscal discipline will surely be tested. **Probably, economic and earnings growth momentum have peaked;** less accommodative monetary and fiscal policy will start to affect markets first and real activity later. We therefore remain with a neutral allocation to equities.

- We remain with an underweight weighting to fixed income on the belief that the yield normalisation process has not played out in full. Whilst central banks in the US, UK and Eurozone are adjusting monetary policies at differing speeds, all are **moving in the same tightening direction as growth conditions remain sufficiently strong enough to do so.**

Equities

Consumer Discretionary	Overweight
Consumer Staples	Neutral
Energy	Underweight
Financials	Neutral
Healthcare	Neutral
Industrials	Neutral
Materials	Underweight
Technology	Overweight
Utilities	Underweight
Telecommunications	Underweight

- Wall Street hit record highs on strong macroeconomic data, robust Q2 corporate results and tax-cut fuelled share buybacks. The Twittersphere buzzing US-China trade war had limited impact on rose-tinted corporate and consumer sentiment. Microsoft, a core holding in our discretionary portfolios, was a notable top performer due to the insatiable demand for its cloud computing offerings. After some momentary jitters, investors compartmentalised the currency crises in a handful of fragile emerging market economies to specific issues rather than a globally systemic problem.

- Global equities remain an attractive asset class for long term investors. The nine-and-a-half-year US stock market rally is the longest in history. However, contrary to popular opinion bull markets do not die of old age. Instead they are killed off by recession or aggressive central bank policy. The third quarter provided little convincing evidence of a developed world recession over the next 12 months or of runaway inflation. Hence, we remain positive about equities. The neutral weight against strategic benchmarks reflects the late stage of the business and interest rate cycles, high US valuations, and tail-risks surrounding escalating trade wars and a possible no-deal BREXIT.

Quarterly Commentary

Fixed Income

G7 Government	Underweight
Index-Linked (US Government)	Overweight
Investment Grade – Supranational	Overweight
Investment Grade – Corporate	Overweight

- Economic growth in the **US** remains above trend and many indicators suggest the economic expansion, whilst mature, still has further to run. Second quarter Gross Domestic Product at 4.2% can only be described as robust and although the pace will certainly moderate in the third and fourth quarters, we expect full year growth in the region of 3%. Inflation at target and a strong employment market, notably with wage increases now at levels last seen at the end of the recession in 2009, have proved sufficient enough for the US Federal Reserve to maintain their tightening cycle. Interest rates were raised for a third time this year in late September to 2.25% and we concur with 12 of the 16 Fed officials who expect another hike in December. Geo-political noise, trade wars and weakness in emerging markets were enough to keep a ceiling on US government bond yields for much of the quarter, however, ten-year yields breached 3% again in September and further normalisation looks set in the coming months. Given our ongoing bearish outlook for the fixed income market and with almost no extra yield compensation for assuming more duration risk, our only conclusion can be to remain defensively positioned.

- As widely anticipated, the Bank of England raised interest rates by 0.25% to 0.75% in August, but we believe that savers waiting for the next tightening will have to be patient, potentially well into 2019. More recently, some **UK** economic indicators have beaten expectations but overall growth conditions remain sanguine, particularly when compared to peers. Inflation ticked marginally higher in the quarter, remaining heavily influenced by the direction of Sterling, which has fallen sharply against the US Dollar and Euro since mid-April. The BREXIT news flow is both relentless and unpredictable and therefore acting as a barrier to new investment – at least until a definitive outcome can be pinpointed. Despite this uncertainty, ten-year UK government bond yields have risen sharply in the quarter but we put this down to two key factors. Firstly, the market had discounted perhaps too much negative news when the yield dipped to 1.18% in July. Secondly, although at different levels, UK bond yields remain correlated to the direction of US government bond yields and when the tide rises in that market, it is powerful enough to take others with it.

Currencies / Interest Rates

RECOMMENDATION - INTEREST RATES			
		CURRENT	DIRECTION
US Dollar	Overweight	2.25%	↑
Sterling	Neutral	0.75%	→ ↑
Euro	Underweight	0.00%	→

- We maintained our overweight **US Dollar** strategy in the quarter which, despite trading sideways for the period, remains approximately 2.5% higher year-to-date in broad value terms. Favourable growth, interest rate and yield differentials provide ongoing support for the currency although the longer term negative ramifications of President Trump's tax cuts and fiscal spending plans cannot be ignored. Over the short term, the uncertain outcome of trade war negotiations should continue to lend support to the US Dollar which appears to have regained its safe haven status. In addition, as the Federal Reserve push on with their interest rate hikes at a quarterly pace, Sterling and the Euro remain very far down the list for those investors seeking positive risk free rates of return.

- Whilst our **Sterling** International Bond strategies remain marginally biased to base currency relative to benchmark, we still consider it prudent to maintain an element of foreign currency exposure. Unsurprisingly, August's 0.25% hike in interest rates had minimal positive impact on Sterling as the future pace of tightening is very uncertain. In fact, excluding inflation, many other key economic indicators are not suggestive of higher interest rates and 'real' inflation adjusted rates are likely to stay deeply negative for the foreseeable future. As mentioned above, BREXIT remains a constant source of uncertainty and we see little merit in attempting to second guess the myriad of possible outcomes.

Quarterly Commentary

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2018-253