Butterfield

Investment Review

4th Quarter 2018

Summary of markets and outlook

Outlook for 2019

The end of the year is an opportune time to reflect on the prior year and layout a framework for thinking about the outlook for the year ahead. At a macroeconomic level, 2018 turned out very much in line with our forecasts. We had penciled in US growth picking up to 2.8% and it looks like it will come in around 3%. We expected the unemployment rate to continue to fall to 3.8% and three to four interest rate rises in the US, the former is looking on the money and we indeed saw four rate rises. On the flipside, we overestimated the potential for inflation to pick up and were surprised by the extent to which the global economy outside of the US slowed.

Over the course of the year, we have written extensively about three topics: higher US interest rates; slower growth outside of the US; and rising tensions between the US and China. Market commentators have debated at length how to weigh the three variables, but overall the impact was increased market volatility, which was something that was expected after the historically low volatility seen in 2017.

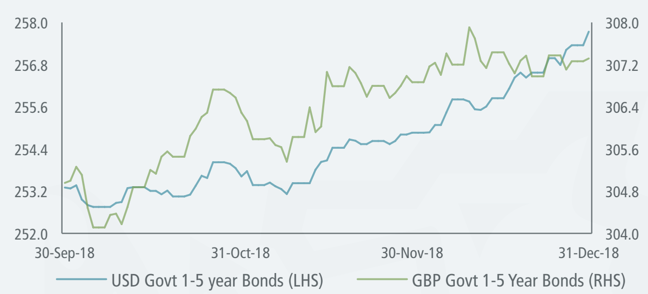
At the end of the third quarter, we discussed the potential feedback loops from the combination of higher US interest rates and economic weakness outside of the US to the US economy and stock market. We made the point that any signs of weakness would impact investors before they impact the real economy. The theme of the last three months is that the market has re-assessed the ability of the US to outpace the rest of the world, which resulted in weaker equity markets and lower Treasury bond yields. Both asset classes are covered in detail below.

Looking forward, we expect the boost that the US received from the tax cut legislation to fade as we progress through 2019 and this is likely to translate into lower growth. We expect US growth to come in slightly lower than consensus, at around 2%. This is a slowdown, but would be closer to trend growth, so is by no means recessionary. There are clearly limits to how far the unemployment rate can fall, but given our growth forecast we expect this to inch down to 3.6%, in line with consensus. With employment still strong, there remain good reasons for the inflation rate in the US to pick up from around 1.9% this year, but the wildcard here is what the US Dollar does and currencies are notoriously difficult to forecast.

Hopefully readers with interests in the UK will forgive us for writing so little about Brexit over the year. While the UK is a relatively small economy when it comes to global growth and overall stock market capitalisation, Brexit is clearly important; particularly for UK-based investors and for the outlook in Europe more generally. We follow a number of very reputable and well-connected research providers and the reality is that no one really knows how it is all going to play out. As we fast approach the 29 March deadline, it seems like the probabilities of either a "hard" Brexit or no Brexit have both increased. However, the most likely outcome remains a "soft" Brexit, given that this has overwhelming support, both in the House of Commons and in the rest of the EU.

In the alternative investment space, performance over the last year has been mixed. Hedge funds have had a difficult year as periods of pronounced volatility (February, October and December) have been challenging for many managers. Gold had a weak first nine months of last year, but recovered in the fourth quarter as demand for safe haven assets rose. Gold has historically been a good hedge against geopolitical risk and this is likely to continue to be a feature during 2019.

Summary of markets and outlook



Fixed Income

Fixed Income markets continued their wild ride in December with credit and risk assets in general sharply weaker as low liquidity amplified already volatile trading conditions. Machine driven trading strategies are clearly driving some of these large moves, especially in equity markets. However, the outlook for the global economy has certainly weakened and become more uncertain, providing markets the justification to trade lower. The Federal Reserve raised interest rates by 0.25%, as we expected, and kept the unwind of their balance sheet largely on autopilot at $50 billion per month. This message was not what markets (or President Trump) had hoped for and a more dovish tilt was expected in light of the recent market behavior. This led credit spreads to trade wider and US Treasuries to price in the possibility of a policy mistake.

December was one of the most active trading months for some time with declines in global equity markets prompting a rally in safe haven assets. US Treasury yields fell by around 0.25% across the curve, leaving 10-year US Treasuries at 2.68%; a dramatic move lower from the high of 3.24% seen in November. With investment grade and high yield credit spreads also wider, we are now approaching levels not seen since January 2016. However, global monetary policy and growth fundamentals were much more supportive during the previous episode, thus investors need to be much more selective this time around before adding risk to portfolios.

Economic data released throughout December was mixed but largely continued with the theme of a gradual slowdown in global activity. However, the US remains more buoyant than Europe and Japan, with the former likely to be further impacted by the removal of ECB support in 2019, potentially leading to much higher yields in Europe which will have an impact on global funding rates. If the US rates market was not excitable enough, rumours that President Trump is also looking to remove Jerome Powell, the Federal Reserve chairman, over his reluctance to support more dovish policy, provided another reason for investors to shy away from risk assets. It also leaves the Treasury Secretary in a precarious position given his recommendation of Powell.

As 2018 came to a close, the markets sent a clear message: the global economy is about to slow down sharply next year. This shift has not only led risk assets and forecasts lower, but also impacted oil. This in turn has forced US inflation expectations back below the Federal Reserve's target and prompted the futures market to cover their record short US rates position, completely pricing out any further increases in the US base rate over the next 12 months. Given this extremely bearish sentiment, we remain defensively positioned. Although in contrast to earlier in the year, the tail risk we now face is that of a positive growth surprise in 2019, which would lead interest rates higher and credit spreads tighter. We therefore maintain our underweight duration call and allocation to investment grade credit until we start to see firm evidence of economic and private sector financial imbalances that could cause a sharp slowdown in the real economy.

Summary of markets and outlook

MSCI World Index ($)

Equities

Equity markets in 2018 can be characterised by a return to normalised levels of volatility. The theme entering 2018 was one of synchronised global growth; a theme that could not hold up through the first 3 months. Global markets, outside of the US, traded in tandem throughout most of the year, whilst the US produced strong returns through September. This stark decoupling ended during the fourth quarter as the risks that hit European and Asian markets earlier in the year caught up with US markets, shrinking the US outperformance gap. Strong investor sentiment was hurt by a combination of fundamental and geopolitical factors.

In terms of performance, the headline MSCI World fell by 8.7%, the first annual decline since 2015. Regionally, North America outperformed for the year, but gave some of that outperformance back during the fourth quarter. North America finished the year falling 5.7%. European, Japanese, and Emerging Markets all struggled throughout the year, returning -14.9%, -12.9%, and -14.6% respectively. On a sector basis, Health Care (one of our portfolio overweights) was the best performing and lone positive sector globally, returning +2.5%. Technology outperformed the MSCI World throughout the year, but struggled in the fourth quarter, mimicking the shape of US market moves mentioned above.

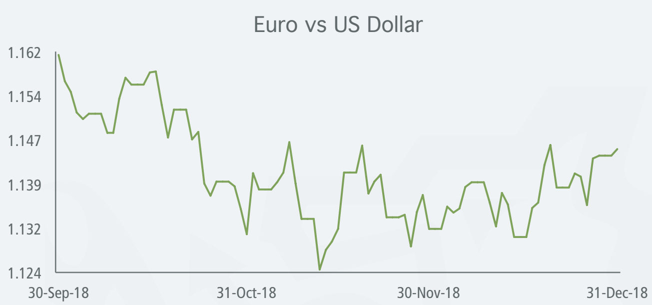
Technology fell 17.7% in the fourth quarter and by 2.6% for the year. The high growth and innovative sector has been hit in recent months by concerns about regulatory risks, valuation, sustainability of earnings growth, and stagnating iPhone sales dragging on Apple and suppliers in the semiconductor industry. Commodity linked sectors also struggled for the year as global commodity prices fell, primarily in the fourth quarter. Crude oil, copper, and even gold fell during 2018, with oil and copper each losing more than 20%.

Equity market fundamentals paint a slightly better picture than recent market moves. Earnings growth is expected to slow, but high single-digit expected earnings growth globally is still strong. Valuations have fallen enough that certain value orientated investors are beginning to see pockets of value in segments of the market that they haven't ventured into for several years. The market is struggling to advance based on fundamental strength. The US Federal Reserve continues to hike short-term interest rates and is shrinking the balance sheet at the same time. Quantitative Easing has turned into Quantitative Tightening and, along with higher interest rates, point to lower equity market multiples, which we have seen. It is challenging to discuss financial markets in 2018 and 2019 without touching on geopolitical issues and the ongoing global trade war. The one thing equity markets dislike the most is uncertainty, and the only certain thing about the trade war is that it creates massive uncertainty. The tariff battle has extended into 2019 despite the 90-day pause between the US and China. Every day it seems there is a headline - negative or positive - relating to the trade war that has shifted investor sentiment, but concrete answers are few and far between.

Summary of markets and outlook

Although increased volatility can create opportunities, we are being extremely selective where we invest new client money as well as where we rebalance existing portfolios. In the second half of 2018, we began moving more money into defensive, safer parts of the market. We like companies and industries that have strong balance sheets and which produce large levels of free cash flow. We are also looking at sectors that perform well later in the business cycle and during economic slowdowns, which appears likely over the next several years. The balanced environment, solid fundamentals coupled with uncertain geopolitical and central bank policies, leads us to begin the year with a neutral stance towards the equity asset class.

Summary of markets and outlook



Currencies

Having started 2018 under pressure, continuing the weaker trend of the previous year, the US Dollar began to recover some of the ground it had surrendered in 2017 during the second quarter. The roots of this recovery centered upon the market beginning to re-price previously underestimated Fed guidance on US interest rate rises on the back of strong economic data in terms of employment and growth. This positive Dollar trend continued during the summer months, pausing briefly for breath at the end of Q3, before again moving higher over the final quarter of the year.

However, it's important to keep 2018's moves in context. The Dollar ended the year 4.74% higher versus the Euro, 5.75% up against the Brexit-beleaguered Pound and 2.67% down on the Japanese Yen. So perhaps not the all-conquering dominance suggested by increasingly positive interest rate differentials favouring the Dollar.

As expected, the Fed raised rates by a further 25 basis points and ratcheted back its 2019 interest rate guidance estimates to two 25bps hikes from three at its December meeting. The market is currently taking a more sanguine perspective and this softer sentiment saw the Dollar partially retrace progress made during the first half of Q4 of 2018.

Interest rate differentials and the ultimate trajectory of US interest rates in 2019 will continue to drive sentiment in terms of the Dollar's value over the next year. If the market was to again have to shift expectations to more closely reflect those of the Fed, we would expect to see the Dollar strengthen again.

In Europe, the European Central Bank (ECB) continues to maintain an unchanged policy in terms of interest rates and has recently downgraded its overall economic projections for the Eurozone economies, which may, in turn, further push back any tightening in European monetary policy.

As has been the case previously, the outlook for Sterling will centre around Breixt and the political and economic ramifications that follow. The current difficulties experienced by UK Prime Minster, Theresa May, in securing the necessary support in parliament to pass the present withdrawal agreement have impacted Sterling's value. Having initially strengthened versus both the Dollar and the Euro at the start of Q4, increased political and economic uncertainty, as a consequence of the current Brexit impasse, saw Sterling weaken further.

At current levels, Sterling appears to still be reflecting a "softer" style Brexit and should such a deal ultimately materialise, the Pound could be expected to recover some ground. However, although the likelihood of Parliament voting for a "harder" Brexit, or indeed no deal at all, is remote, the spectre still remains and we would expect Sterling to fall should the possibility of either of these scenarios increase.

Having remained under pressure since the second quarter of 2018, the Yen staged a partial recovery during the final quarter, appreciating against both the Dollar and the Euro. These recent moves can, in many ways be attributed to the Yen benefiting from the currency's position as a "safe-haven", particularly at times of US Dollar uncertainty. We remain of the opinion that looking longer term, the Yen has limited

Summary of markets and outlook

scope for sustained appreciation. With interest rate and bond yield differentials continuing to increasingly favour the US and the Bank of Japan's ongoing commitment to apparent "indefinite" quantitative easing, we continue to view the potential for sustained Yen appreciation as limited at this point.

Summary of sector views

1 Max underweight | 2 Underweight | 3 Neutral | 4 Overweight | 5 Max overweight

Sector	View	Commentary
Consumer discretionary	2	**Underweight**: The sector performs well early in the business cycle, but as we near the latter part of the current cycle, it is prudent to trim exposure. Rising interest rates will begin to hurt the consumer in the form of higher mortgage, credit card, and student loan repayments. There is also a coming liquidity crunch in the retail sub-sector with debt maturities increasing relative to the past five years. The sector has performed well over the past year, but excluding the impact of Amazon's strong performance, the sector is underperforming the MSCI World. We strive to maintain a less-than-benchmark exposure to the sector, while having a neutral, or overweight, exposure to large and structurally important companies such as Amazon.
Consumer staples	3	**Equal weight**: The sector continues to trade in line with the broad market. Consumers remain resilient, particularly in the US, as wages slowly increase and the number of job vacancies start to outnumber available qualified labour. Aggressive global trade negotiations and higher interest rates should provide tailwinds given the defensive characteristics of the sector.
Energy	3	**Equal weight**: Having lagged the broader market at the start of the year and out-performed during second quarter, the Energy sector again disappointed during the second half of 2018. Global oil prices suffered a sharp selloff during the third quarter, with both the price of Brent and WTI falling by almost 40%. The key catalysts were lower demand estimates from non-OECD economies led by China, and the announcement from the US that it would issue sanction waivers to the leading buyers of Iranian oil until at least May 2019. In response, OPEC and its alliance partners announced in December their agreement to again cut production for an initial period of six months by a total of 1.2 million barrels per day. We continue to remain neutrally positioned until a clearer picture of sustainably higher longer term oil prices becomes more apparent.
Financials	3	**Equal weight**: Financials broadly tracked the market lower during the final quarter. However, for the year as a whole, the sector has significantly underperformed the market following periods of disappointing performance during the first three quarters. Looking forward, the outlook for the sector is mixed. Traditionally, a rising interest rate environment tends to be positive for the sector, but a more recent flattening of the yield curve, combined with Banks in the US needing to start passing on higher short-dated deposit rates, suggests that the ongoing improvement in net interest margins is coming to an end. Furthermore, with the global economic outlook weakening, there isn't likely to be much in the way of improvement in credit fundamentals. To this extent, we remain neutrally positioned, relative to other sectors at present.
Health care	4	**Overweight**: We maintain our positive view of the sector as we continue to see innovation in the areas of diagnostics, monitoring and medical data analysis as well as successes in new drug therapies. Demand is underpinned by the needs of an ageing global population and increasingly affluent developing economies, where greater affordability is driving a rise in demand for improved medical care. Taking diverse exposure comprising medical equipment manufacturers, managed care providers and broadly based large cap pharmaceutical companies remains our primary focus. A strong long-term growth story.

Summary of sector views

1 Max underweight | 2 Underweight | 3 Neutral | 4 Overweight | 5 Max overweight

Industrials	4	**Overweight**: The sector traditionally performs well in the latter stages of the business cycle as capital investment is strong and producers have greater pricing power. The sector has a high degree of leverage to economic growth, which remains strong in the US, although global growth is moderating. Protectionism is a threat to the sector, but this risk is reflected in valuations which remain relatively attractive. The sector has exposure to positive trends in transportation and defense, although exposure to the energy sector is a risk given the lower price of oil.
Information Technology	3	**Equal weight**: The IT sector dropped by 17.70% during what was its weakest quarter in a decade. Continued news around slowing global growth in the world's two largest economies, topped with tensions around trade tariffs and high profile arrests, have created a perfect storm for this sector. We remain neutrally weighted based upon our thesis that capital spending by companies on IT is set to continue, and we will see further investment in cloud and artificial intelligence technology globally over the next decade. The Internet of Things and continual adoption of technology globally will continue to support this sector. Company Balance sheets and strong cash flows will enhance shareholder returns, and we expect further share buy backs and, in some cases, special dividend payments to complement this.
Materials	3	**Equal weight**: The metals and mining sub-sector has been typically volatile as the market reflects the uncertain prospects for the Chinese economy, particularly the construction sector. The market continues to work off a long period of oversupply but company balance sheets are in much better shape than they were. The Chemicals industry has seen an increase in M&A activity, which has supported stock prices. Attractive valuations and a continued focus on cost cutting within the sector lead us to maintain our equal weight stance.
Real Estate	3	**Equal weight**: The sector looks expensive based on an adjusted "funds from operations" yield relative to history, but looks close to fair value based on NAV and in relation to broad equities. The sector benefits from a favourable cyclical backdrop (with the exception of retail malls), but rising interest rates in the US keep us equal weight.
Communication Services	2	**Underweight**: We initially adopt an underweight stance to the newly formed Communication Services sector. Of the four sub-industries, we are neutrally weighted to Interactive Media & Services, which is expected to grow revenue and earnings above that of the overall market, and Entertainment, which should benefit from shifting consumer dynamics away from linear TV to streaming video services. The latter reasoning compels us to be underweight Media, which comprises traditional cable companies who are now facing significant headwinds to growing their subscriber base. Although we remain underweight Telecommunications, we are looking to add exposure, given increasingly favourable wireless fundamentals and its defensive characteristics in the event of a business cycle turn.
Utilities	2	**Underweight**: While some of the industry's defensive qualities have led the sector to outperform the broader market over the quarter, there remains a concern that high debt levels will only become harder to service in a rising rate environment. This zeitgeist of recent years on anticipating future interest rate movements unfortunately overshadows the increasing emphasis on infrastructure and environmental investments, which ultimately leads to improved earnings growth. We believe this factor, along with large capex requirements and significant regulatory intervention continues to justify our underweight stance.

Quarterly statistics

Equity Indices	3 Month % Change 30 Sep 18 to 31 Dec 18	6 Month % Change 30 Jun 18 to 31 Dec 18	9 Month % Change 31 Mar 18 to 31 Dec 18	12 Month % Change 31 Dec 17 to 31 Dec 18
Global				
MSCI World Index	-13.42	-9.10	-7.53	-8.71
MSCI World Index (Sterling)	-11.40	-5.91	+1.82	-3.14
MSCI World Index (Euro)	-12.19	-7.32	-0.46	-4.17
MSCI Emerging Markets Index	-7.47	-8.49	-15.77	-14.58
United States				
Dow Jones Industrial Average	-11.31	-2.77	-1.54	-3.48
S & P 500 Index	-13.66	-7.13	-4.08	-4.94
NASDAQ Composite Index	-17.29	-11.16	-5.29	-2.84
Europe				
Continental Europe - Dow Jones Euro Stoxx 50	-11.47	-11.15	-8.55	-12.03
France - CAC Index	-13.56	-10.65	-5.63	-8.00
Germany - DAX Index	-13.78	-14.20	-12.71	-18.26
Switzerland - SMI Index	-7.25	-1.99	-1.59	-7.04
UK - FTSE 100 Index	-9.64	-10.24	-1.64	-8.73
Far East				
Asia - MSCI Asia Pacific Index (US Dollars)	-10.96	-10.52	-13.48	-13.52
China - Shanghai Composite	-11.61	-12.42	-21.30	-24.59
Hong Kong - Hang Seng Index	-6.73	-9.16	-11.50	-10.69
Japan - Nikkei 225 Index	-16.78	-9.36	-5.59	-10.29
MSCI World Sectors				
Consumer Discretionary	-14.52	-10.80	-7.18	-5.51
Consumer Staples	-6.78	-4.37	-5.09	-10.10
Energy	-21.67	-21.06	-11.03	-15.84
Financials	-13.85	-11.53	-15.33	-16.97
Healthcare	-9.43	+0.98	+3.79	+2.51
Industrials	-16.29	-11.17	-13.12	-14.54
Information Technology	-17.70	-10.99	-5.81	-2.60
Materials	-13.91	-14.37	-12.98	-16.93
Real Estate	-4.65	-5.64	-2.65	-6.36
Telecommunications Services	-6.78	-1.58	-4.43	-10.02
Utilities	+0.46	+1.35	+3.75	+1.97

Quarterly statistics

Equity Indices	3 Month % Change 30 Sep 18 to 31 Dec 18	6 Month % Change 30 Jun 18 to 31 Dec 18	9 Month % Change 31 Mar 18 to 31 Dec 18	12 Month % Change 31 Dec 17 to 31 Dec 18
Bond Indices				
Bloomberg Bond Indices - US Govt 1-5 Year	+1.75	+1.80	+1.92	+1.51
Bloomberg Bond Indices - UK Govt 1-5 Year	+0.77	+0.60	+1.08	+0.39
Bloomberg Bond Indices - Canada Govt 1-5 Year	+1.51	+1.38	+1.65	+1.89
Bloomberg Bond Indices - Euro Govt 1-5 Year	+0.91	+0.36	-0.20	+0.00
Foreign Exchange Rates				
Sterling versus US Dollar	-2.27	-3.40	-9.18	-5.75
Sterling versus Euro	-0.88	-1.50	-2.25	-1.07
Sterling versus Swiss Franc	-1.62	-4.28	-6.36	-4.85
Sterling versus Canadian Dollar	+2.90	+0.12	-3.98	+2.50
Sterling versus Japanese Yen	-5.56	-4.35	-6.22	-8.19
US Dollar versus Euro	+1.39	+1.93	+7.10	+4.74
US Dollar versus Swiss Franc	+0.67	-0.93	+3.11	+0.94
US Dollar versus Canadian Dollar	+5.29	+3.64	+5.70	+8.76
US Dollar versus Japanese Yen	-3.38	-1.01	+3.24	-2.59
Trade Weighted US Dollar Index	+2.03	+2.19	+6.58	+5.10
Commodities				
Reuters/Jefferies CRB Commodity Price Index	-12.99	-15.26	-13.08	-12.41
Gold Spot $/Oz	+7.53	+2.35	-3.15	-1.58
Silver Spot $/Oz	+5.72	-3.86	-5.19	-8.54
Brent Crude Index (London)	-32.48	-32.62	-20.44	-21.50
Crude Oil Futures (New York)	-38.01	-38.76	-30.07	-24.84

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