Butterfield

Global strategy
Don't call it a Currency War…yet?

Fixed income
The Fed delivers for some

Equities
A decent US earnings season

Global asset allocation

Investment Views
August 2019

Global strategy

Don't call it a Currency War…yet?

One of the features of Trump's presidency is that communication from the White House has been far more direct than it has been historically, with Twitter being the primary channel. One of the challenges this presents is that investors need to try to distinguish the bluster and off-the-cuff noise from useful signals about the potential direction of future policy. An area that has recently been the subject of much debate is the US dollar. More specifically, is the strength of the dollar a problem for the US economy, and if so, could US authorities intervene to weaken the dollar and would any such policies have a chance of working?

It is not new that Trump has strong views about macro policy and we have previously written about his efforts to influence interest rates by pressuring the Federal Reserve to cut rates. However, as the US economy has slowed this year, and the global economy has slowed materially, there has been an increase in commentary around the role of currencies. A speech by the president of the European Central Bank (ECB) in mid-June prompted Trump to tweet: "Mario Draghi just announced more stimulus could come, which immediately dropped the Euro against the Dollar, making it unfairly easier for them to compete against the USA. They have been getting away with this for years, along with China and others."

The historical context here is that, since 1995, the US has had a strong dollar policy, with Treasury Secretaries periodically re-stating the belief that a strong US dollar is in the best interests of the United States and the world. But it is well known that Trump has little regard for past conventions, and if anything, he seems to relish challenging them in order to make up for past "mistakes" and "injustices." One of the key considerations is that areas where the White House has executive power, such as trade policy, have had greater implications for markets than areas where the President is constrained by legislative/institutional constraints. This is where currency policy quickly gets complicated.

Beyond verbally pressuring the Federal Reserve, the options open to the President quickly run into considerably more institutional resistance. Congress needs to approve appointments to the

Global strategy

Don't call it a Currency War…yet? *(continued)*

Federal Reserve Board, the Treasury Secretary is far more cognisant of the significance of a change to the strong dollar policy, and central bank independence is still protected by the Federal Reserve Act of 1913. The US does have an Exchange Stabilization Fund, but the size is very small relative to the overall market, so use of this would be symbolic more than anything. The fund was last used in 2011 during a coordinated intervention by G7 central banks to weaken the Japanese yen after an earthquake and tsunami caused it to spike sharply.

There are three reasons to think that this debate isn't going anywhere soon: the argument that countries have manipulated their currency is not without merit; the US dollar is overvalued based on traditional valuation metrics, and a strong dollar does disadvantage US manufacturers. In the early 2000s China managed their currency to stem appreciation in order to pursue an export-based growth strategy, while central banks in the Eurozone and Japan have both implicitly tried to weaken their currencies to boost nominal GDP growth. However, China stopped manipulating its currency lower years ago, while simulative monetary policy in the Eurozone and Japan is the result of other more structural factors.

Overall, managing currency values in a market where global FX trading exceeds $5 trillion a day is incredibly difficult. The only way to get a sustainably weaker dollar is a pickup in growth in the rest of the world. With China managing a tricky economic transition, Europe still opposed to fiscal policy and Brexit uncertainty still an issue; it may well be a while until this happens. Meanwhile, the chance of a global agreement to weaken the dollar, similar to the Plaza Accord in 1985, remains remote. It is therefore likely that we will continue to see Trump bemoan dollar strength and "manipulation" by others. We are not currently in a currency war, but it is certainly something to watch and we have recently added to our gold exposure where appropriate to help hedge this risk.

Fixed income

The Fed delivers for some

In a defining moment for this business cycle, and in an attempt to get ahead of the curve, the Federal Reserve reduced interest rates for the first time in over ten years at its policy meeting in July, helping to drive the S&P 500 to a new record high. Whilst the much hyped “insurance cut” of 25 basis points (bps) in the base rate was lower than some market participants had wanted, with a probability of a 50bps move rising to nearly 40% during the middle of the month, the addition of an early end to quantitative tightening and the acknowledgment that further signs of economic weakness will prompt action was probably the most that the central bank could do at this stage with employment and consumer spending still strong. However, the bond market and the U.S. President, which now control by proxy the long end of the U.S. Treasury curve, are likely to be dissatisfied, not only with the small move but also the hawkish language that followed the decision. 2020 is an election year in the US and there are multiple trade wars being fought, so expect further pressure on the Federal Reserve’s independence in coming months.

Although the US yield curve remains positively sloping at +14bps, it remains dangerously close to inversion and dependent on three further cuts of 25bps to the U.S. base rate over the next year in order to maintain this spread. Although with quantitative easing distorting term premiums on global government bonds, this measure is not as relevant as in previous cycles, it still remains important from a confidence point of view. Looking ahead to the next Fed meeting in September, the market is pricing in another 25bps cut to the US base rate; whether this translates into reality will be dependent on economic data and the performance of risk assets which are vulnerable to central bankers who wish to preserve their independence.

U.S. economic data was broadly positive during the month, with manufacturing and services PMIs stable and non-farm payrolls holding steady at +164k, leaving the six month average at a respectable +140k, which is at the top end of the range of where

Fixed income

The Fed delivers for some

(continued)

we could expect the US economy to continue adding jobs with the unemployment rate at 3.7%. We also saw the first estimate of Q2 U.S. GDP which registered annualised growth of +2.1%. Although lower than the +3.1% seen in Q1, the internals were much healthier, boosted by solid consumer and government spending. Inflation indicators also rebounded with core Personal Consumption Expenditure (PCE), the Fed's preferred measure, rebounding to +1.8%, just shy of target with other indicators such as the trimmed mean PCE and various employment measures all pointing to continued solid domestic spending driving U.S. growth and inflation.

Outside of the U.S., politics dominated European news as the UK installed a new prime minister intent on fulfilling the 2016 Brexit referendum with a "do or die" pledge. Interestingly, UK Gilt yields rallied on this news, even as Sterling tumbled. Headlines are likely to become dominated by a much more confrontational strategy with the EU, and could well lead to an early election in the UK in Q4. Although UK assets are cheap in U.S. dollar terms, we prefer to wait until we see clarity over an early election with a labour government now very close to power. In the Euro area, bond yields continued their march towards negative territory, with 30-year bonds declining to 0.12%, a "real" yield of -2%! With the ECB running low on new options to stimulate the economy and borrowing yields at extreme lows, fiscal stimulus should now be enacted by European governments, with a conservative estimate of US$275 billion in annual fiscal spending available, there are still traditional options available to drive growth. Further, 100-year government bond issues will now start looking very attractive as the scramble for yield continues and governments should take advantage of this.

In terms of positioning, we have made very few changes over the past month, as we had previously tilted towards a more defensive strategy, primarily dialing back exposure to corporate bonds. This still makes a lot of sense with the VIX and MOVE volatility indices at low levels, and the notoriously low liquidity month of August approaching. Global growth continues to disappoint, so any volatility in risk assets would have to be extreme for us to add risk at this point although, we remain nimble and ready to deploy capital if we witness the correct conditions.

Equities

A decent US earnings season

Despite all of the recent economic and geopolitical fireworks over the past week, equity markets experienced a relatively quiet July, and ended the month with a small positive gain. Investors have been focusing recently on the second quarter earnings season, in addition to further trade discussions between the US and China. Trump's top trade and treasury advisers met with Chinese officials late in the month for the 12th round of negotiations. US Trade Representative Robert Lighthizer and Treasury Secretary Steve Mnuchin returned to the US without an agreement in place, not a surprising outcome at this point, but still sending global equities lower on the news. At a headline level, the MSCI World Index increased 0.5% during July, driven by strength in North American markets.

Expectations heading into this earnings season were as bearish as we have seen over the past two years, as higher input costs and the trade war are driving earnings growth lower. Equity analysts were calling for S&P 500 earnings to fall into negative territory relative to the same quarter of 2018. But, in typical fashion, actual earnings came in higher than expectations and are currently showing some positive growth, at just over 1%. The current state of earnings growth is a stark comparison to what was experienced in 2018, solid double-digit growth due to a strong underlying economy and the benefits of a lower corporate tax rate. Having said that, it was expected that 2019 would be a year of two halves, with the first half of the year showing small gains in earnings figures, while the second half of the year would be much stronger. The slowdown can be attributed in part to the technology sector (broadly expected), which has been the growth engine of equity markets over the past 12 months. Technology company earnings contracted 6.5% relative to 2018, due to struggling semiconductor and hardware sectors; the portions of

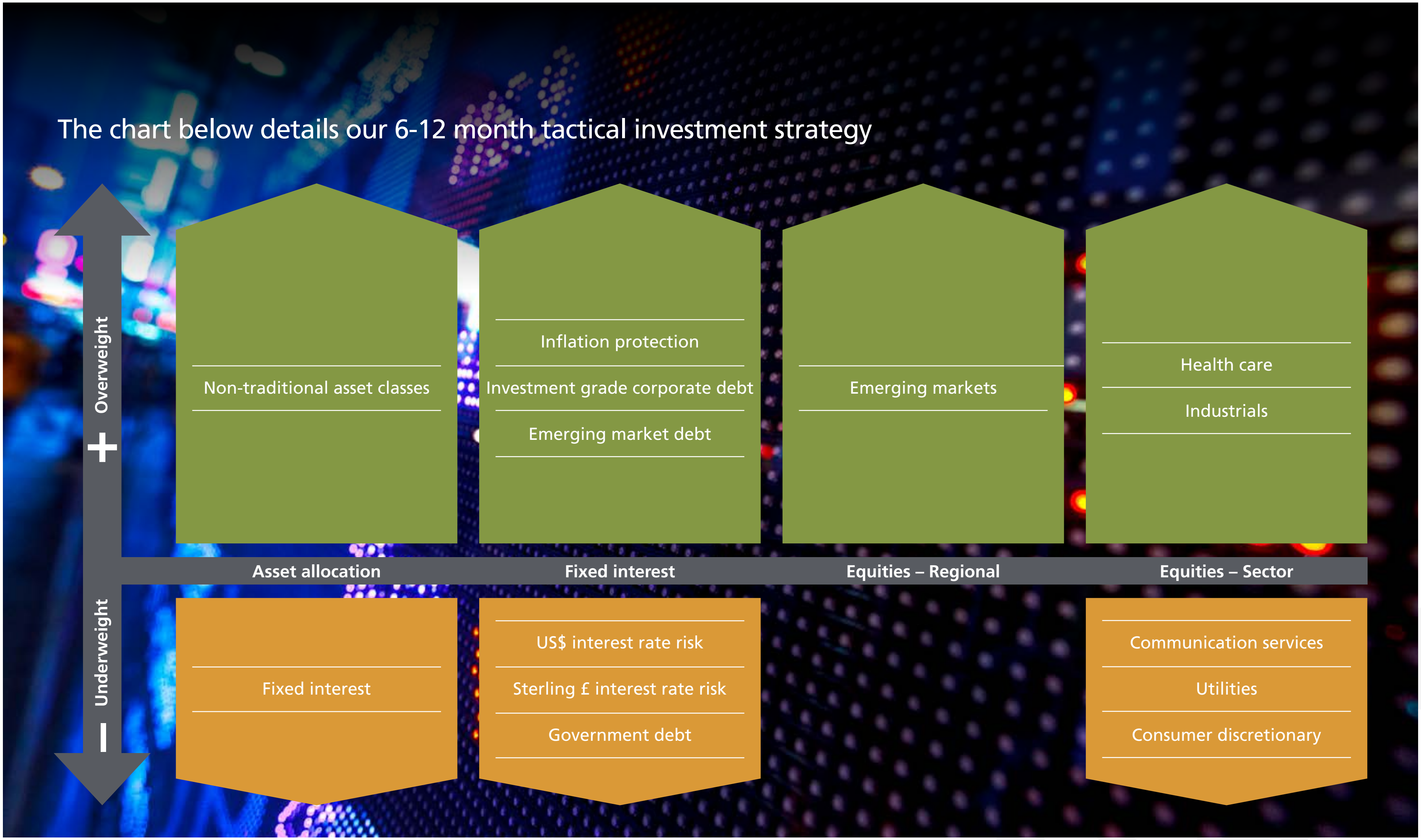
Equities

A decent US earnings season *(continued)*

the sector hit hardest by slowing global trade. It is not all gloomy within technology; the software sector – an area we continue to favour due to the minimal impact from the trade war – continues to show strength, growing 11% year over year. There are two shifts that our portfolios have been exposed to over recent years: the movement from on-premise software to "the cloud"; as well as the early stages of the broader economy moving to a cashless environment. Companies such as Microsoft and Oracle have been growing their cloud and subscription businesses, with great success. Both companies posted very strong quarterly results. In the payment space, the largest players – Visa and MasterCard – also reported solid results, as the strongest part of the global economy is the consumer, and consumers are spending more of their disposable income using credit instead of cash.

We continue to see signs of solid economic data in the form of a strong employment market globally and solid personal consumption figures. With that said, abrupt shifts in risk on/risk off sentiment on the heels of fluid trade policy from both sides of the trade war continue to create challenges relying on fundamentals alone. We remain comfortable with our neutral stance towards the equity asset class, but under the hood we are looking at sectors and themes to achieve a slight defensive tilt in portfolios.

Global asset allocation



Disclaimer

This document and the information contained herein has been prepared and issued by Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited and Butterfield Bank (Guernsey) Limited and is for illustrative purposes only. It neither constitutes investment advice nor is it an offer or an invitation to acquire or dispose of any securities and should not be relied upon as such. Prior to making any investment decision a financial adviser should be consulted. Products and services are available in the respective home jurisdictions and only in those other jurisdictions where they may be legally offered or obtained.

The data source for this document is Bloomberg unless explicitly stated otherwise and is believed to be accurate as at the date of publication and may be subject to change without notice. Whilst every care has been taken in producing this commentary, neither the author nor Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited, nor Butterfield Bank (Guernsey) Limited shall be liable for any errors, misprints or misinterpretation of any of the matters set out in it. Past performance is not necessarily a guide to future performance. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. In the case of some investments, you should be aware that there is no recognised market for them and that it may therefore be difficult for you to deal in them or to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors. Before contemplating any transaction, you should consider whether you require financial advice.

Butterfield Asset Management Limited is licensed to conduct investment business by the Bermuda Monetary Authority. Registered Office Address: 65 Front Street, Hamilton HM12, Bermuda.

Telephone: +(441) 299 3817. Website: www.bam.butterfieldgroup.com.

Butterfield Bank (Cayman) Limited is licensed to conduct securities investment business by the Cayman Islands Monetary Authority. Registered Office Address: Butterfield Place, 12 Albert Panton Street, George Town, Grand Cayman KY1-1107, Cayman Islands.

Telephone: +(345) 949 7055. Website: www.ky.butterfieldgroup.com.

Butterfield Bank (Guernsey) Limited is licensed and regulated by the Guernsey Financial Services Commission under the Banking Supervision (Bailiwick of Guernsey) Law, 1994, The Protection of Investors (Bailiwick of Guernsey) Law, 1987 and the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc. (Bailiwick of Guernsey) Law, 2000, each as amended from time to time. Registered Office Address: P.O. Box 25, Regency Court, Glategny Esplanade, St Peter Port, Guernsey, GY1 3AP. Company registered in Guernsey No. 21061.

Telephone: +44 (0)1481 711521. Fax: +44 (0)1481 714533.
Website: www.gg.butterfieldgroup.com.

Telephone calls are recorded for training, regulatory and security purposes.

August 2019