Butterfield

Investment Review

1st Quarter 2019

Summary of markets and outlook

Slow-motion shifts

If one were to ask the average member of the public what central banks do, then the most likely answer would probably be "to set interest rates" or perhaps "keep inflation under control". However, if one were to ask the same question to someone working in financial markets then the answer is likely to be "it's complicated". Over the last few decades, central bank thinking has been significantly influenced by a very damaging period of high inflation in the mid-1970s, such that a 2% inflation target has been a key central bank policy objective in pursuit of stable prices. However, the period since the financial crisis has been more about avoiding deflation rather than keeping inflation and inflation expectations under control. This has particularly been the case in Europe and Japan, but also to a lesser extent in the United States and the UK.

One of the most important themes over the first quarter was the Federal Reserve's extraordinary shift in tone regarding future rate rises, compared to that of 2018. At the end of September last year the median policymaker expected to raise rates three times in 2019, but this was recently reduced to zero. The near-term implications for bond and equity markets are covered in detail below. There is however a broader question of whether the deterioration in economic fundamentals really justified such a dramatic shift, or whether there has been a more fundamental shift in the way the Fed thinks about how the economy operates and what causes inflation.

President Trump has publically criticised the Central Bank and Chair Jerome Powell in particular. Initially, this probably had the opposite of the intended effect i.e. it discouraged the Fed from sounding too dovish in an attempt to prove their independence. However, as markets priced in a materially weaker growth outlook, the Fed either had to react to this or run the risk of being blamed for causing a slowdown, which in this era of populism could be very damaging to their credibility, with Washington and the public more widely. Underlying all of this is potentially a subtle shift away from a framework that targets 2% inflation each year to one that tries to make up for previous inflation undershoots and waits to actually see inflation rather than acting preemptively.

That inflation has been "the dog that did not bark" has allowed the goldilocks trade—where investors make money on both bonds and equities—to reassert itself after a very painful fourth quarter last year. If the Fed really is prepared to have a higher tolerance to inflation, then this would be a significant change. The move would likely extend the current economic cycle, which is positive for equities, as they have never made a cycle high more than 12 months before the start of a US recession. It is possible that the deterioration in growth warrants the shift that we have seen and that the Fed has tried to get ahead of the slowdown, rather than react too late. We will know a lot more about how this story develops when the Fed undertakes a strategy review, which is scheduled for June. In the meantime, the market has priced a more optimistic growth outlook, so probably needs to see more stable economic numbers in the second quarter to provide a foundation for stronger growth in the second half of the year.

Summary of markets and outlook

Fixed Income

With risk assets continuing to ascend and bond yields hitting fresh lows, we have witnessed a first quarter where most investors made money regardless of the asset class they were allocated to. While market participants have known that the US economy was due to weaken as the fiscal stimulus ran its course, it was only at the very start of the fourth quarter that policy makers in the US signaled that they were a long way from neutral (the interest rate that is high enough to contain inflation pressures but not too high as to cause unemployment to rise), prompting markets to expect another three base rate increases over the following twelve months. We of course then witnessed risk assets falling and this episode clearly impacted the Fed's outlook, this was also compounded by the US economy showing firmer signs of economic weakness.

As discussed above, the reason for the magnitude of this pivot is unclear at this stage. Policy markets could be acting pro-actively in an effort to engineer a soft landing, an outcome that no major central bank has been able to successfully accomplish, but if it becomes clear that the economy is in fact stronger than expected then the risks will likely manifest in financial instability i.e. asset price bubbles.

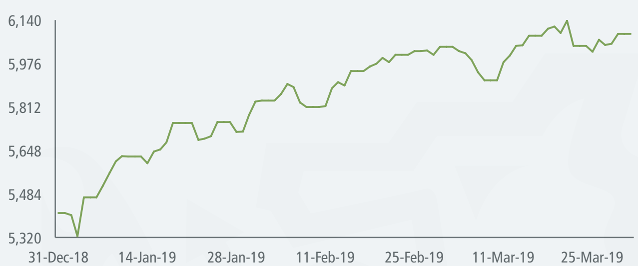
On the economic front, data releases in the US remain mixed, softer yes, but nowhere near recession levels, which makes the massive move lower in US Treasury yields slightly confusing, especially as risk assets seem completely unfazed by any talk of recession. These recent moves have now inverted the yield curve at short maturities with the usually reliable three month versus ten-year curve trading down to -7bps. The bond market now prices in a 70% probability of a cut to the US base rate in 2019 and two full cuts over the next 24 months. In our opinion, this outcome is only likely if policy makers are faced with a full blown recession and with that, credit spreads and equities could be very vulnerable at these levels. Hence, whilst the sun is shining, we have continued to reduce credit risk where appropriate.

Outside of the US, we are seeing some signs of green shoots in Asia, but continue to see weaker data in Europe. Germany in particular has seen a severe manufacturing slowdown which has led to ten-year Bund yields falling into negative territory for the first time since 2016. This has had implications for global bond yields, explaining some of the recent rally in US Treasuries, as the US remains one of few sovereign's with a positive real yield. In the globalised economy, a potential recovery in Asia should in time support the economies of Europe and the US. If we do see stabilisation in growth and inflation outlooks, then running an underweight interest rate risk position would enable investors to avoid capital losses in their portfolios as yields rise.

Given our preference for the US to avoid a recession this year, we have taken this opportunity, with ten-year US Treasuries at 2.41%, to reduce exposure to the long end of the curve in appropriate mandates. In addition, we also used the recent weakness in inflation expectations to increase our TIPS (Treasury Inflation Protected Securities) positions. The Fed's recent dovish pivot was in part due to sticky inflation expectations (PCE inflation remains below 2%), in spite of buoyant employment and wages trending higher. If they are successful in resetting expectations portfolios should benefit, especially if monetary policy does turn out to be too easy for the US economy.

Summary of markets and outlook

MSCI World Index ($)



Equities

Investors in equity markets could breathe a sigh of relief in the first quarter, as a broad based recovery has brought global markets within striking distance of all-time highs. The MSCI World continued the "V" shaped recovery pattern during the first quarter of 2019 – returning 12.5%. Recent risk asset performance has been driven by a battle between global growth and monetary policy stances. In the fourth quarter of 2018, global growth had clearly slowed and the Fed seemingly had a hawkish tone, which sent equities close to bear market territory. Fast forward three months, the Fed has turned dovish, and growth expectations have fallen so much that the market could be underpricing a recovery.

Absent an earnings recession, this is clearly an environment in which equities can perform well – evidenced by the strong returns during Q1. The Fed has hit the pause button on further rate hikes in the short-term, inflation is not running rampant anywhere in the world, global earnings expectations call for 4.5% growth in 2019, and valuations are far from stretched. Despite solid single digit growth in expected earnings, it is often the change in expectations that is more important. While bottom up European (ex UK) earnings are expected to grow 6.8% in 2019, which leads all global regions, only 3 months ago that same figure was 9.2%. Similar decreases can be seen in the US and Asia. Earnings expectations have been hit by higher input costs, wages and commodity costs, as well as slower top line revenue growth.

The other important factor worth examining at the moment is the disconnect between bond and equity markets. Inversion has occurred at specific points on the yield curve, which have historically had strong predictive power towards recessions. While we are aware of the relationship between yield curve inversion and amount of time until the occurrence of recessions, and thus a fall in equity prices – the yield curve inversion is only one factor in determining whether equity markets will fall and when that fall will actually begin. Equity markets have continued to climb higher and have ignored the signals that are flashing red in the bond market, both the inversion and levels of yields. Meanwhile, the message from corporate credit spreads is much more supportive.

At a regional level, the dispersion of returns is similar to that of 2017 and the first half of 2018. North America has posted the strongest gains, with all other regions underperforming the headline MSCI World. The rationale for North American outperformance has been the region's reliance on the technology sector relative to Europe's reliance on the financial sector. Technology is the largest sector in US equity markets and has been the strongest performing sector in 2019, while financials, the largest sector in Europe, has struggled thus far in 2019. Despite the financial sector's poor relative performance, absolute returns have been solid in all 11 global sectors. It is however important to examine what equity markets have done over the past 6 months – a broad based quasi bear market followed by a strong recovery. The financial press loves large market moves, but they are uncomfortable for us as investors. If we were to combine the "bad" (Q4 2018) and the "good" (Q1 2019), global equity markets have fallen slightly over the past six months, with the outlook for equities mildly positive for the rest of 2019.

Summary of markets and outlook

Currencies

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Summary of markets and outlook

Summary of sector views

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

Sector	Rating	View
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 in line with the broad market 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 underperformed the broader market during 2018, the Energy sector enjoyed a more positive start to 2019, helped by a recovery in spot oil prices, no further downgrades to global demand expectations and reasonably supportive corporate results. With global oil demand estimates having a close correlation to GDP, slower growth expectations in China and the Global Economy were the key catalysts behind previous sector weakness. While at a corporate level, strong capital discipline and improving free cash flow generation are positive drivers, we remain neutrally positioned until a clearer picture of demand growth emerges that's sufficient to underpin sustainably higher longer term oil prices.
Financials	3	**Equal weight**: The sector has underperformed the broader market over recent times. The recent shift in stance on monetary policy from the Fed has certainly weighed on hopes of further margin expansion within the traditional banking sector. Looking forward, the case for financials is balanced. On one side, there is no doubting that the market is cheap from a valuation perspective. However, opposing this remains a combination of fundamentals, which are not overly compelling, while specific risks, especially in relation to Europe, could also weigh on the sector. To this extent, we remain equal weight with focus upon the US over the rest of the world.
Health care	4	**Overweight**: Despite recent headwinds arising from the uncertainty of the future shape of the US healthcare model, a number of medium to long-term positive trends remain in place which should continue to support companies within the sector as a whole. Evolving demographics in both developed and emerging economies will continue to underpin demand for treatments for chronic conditions arising from lifestyle choices and aging populations, with greater affluence in developing economies driving demand for newly affordable healthcare solutions. Our view remains that, whilst drug pricing pressure and political agendas remain an intrinsic part of the healthcare landscape, strong earnings growth and positive long-term secular trends continue to warrant an overweight stance within the sector.

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**: Despite slowing growth in the US and China, last quarter's fall of 17.70% was largely erased in Q1 of 2019. The continued noise around trade tariffs seems to be moving to a potential resolution, semi-conductors appear to have turned a corner and the initial shock of declining smartphone sales is subsiding. Capital spending by companies on IT is set to continue and we will see further investment in cloud and artificial intelligence technology across the globe over the next decade. Company Balance sheets and strong cash flows will enhance shareholder returns, and we expect further share buybacks 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**: The sector has largely kept pace with that of the broader market in 2019 aided by a benign competitive landscape relative to previous years. We remain underweight the sector as concerns around privacy regulation and anti-trust legislation surrounding industry heavyweights has increased. Looking further ahead, the sector should benefit from several long-term secular trends such as the next generation of 5G wireless broadband, the exponential growth in streaming video content online and in Google's case, Cloud computing. Since the last quarter we have increased exposure to the Telecommunications sub-sector that ties in with the growth drivers mentioned above.
Utilities	2	**Underweight**: While predictive cash flow and attractive dividends support a case for maintaining a presence within the sector, there remains a concern that high debt levels will only become harder to service in a higher rate environment. This zeitgeist continues to overshadow 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 oversight - justify our underweight stance.

Quarterly statistics

Equity Indices	3 Month % Change 31 Dec 18 to 31 Mar 19	6 Month % Change 30 Sep 18 to 31 Mar 19	9 Month % Change 30 Jun 18 to 31 Mar 19	12 Month % Change 31 Mar 18 to 31 Mar 19
Global				
MSCI World Index	+12.48	-2.61	+2.24	+4.01
MSCI World Index (Sterling)	+10.34	-2.24	+3.82	+12.35
MSCI World Index (Euro)	+14.80	+0.80	+6.40	+14.27
MSCI Emerging Markets Index	+9.91	+1.71	+0.60	-7.41
United States				
Dow Jones Industrial Average	+11.81	-0.84	+8.71	+10.09
S & P 500 Index	+13.47	-2.02	+5.38	+8.84
NASDAQ Composite Index	+16.81	-3.39	+3.77	+10.63
Europe				
Continental Europe - Dow Jones Euro Stoxx 50	+12.17	-0.69	-0.34	+2.58
France - CAC Index	+13.39	-1.98	+1.31	+7.01
Germany - DAX Index	+9.16	-5.88	-6.34	-4.72
Switzerland - SMI Index	+13.77	+5.53	+11.51	+11.97
UK - FTSE 100 Index	+9.49	-1.07	-1.72	+7.69
Far East				
Asia - MSCI Asia Pacific Index (US Dollars)	+9.64	-2.38	-1.89	-5.14
China - Shanghai Composite	+23.93	+9.55	+8.55	-2.47
Hong Kong - Hang Seng Index	+12.84	+5.24	+2.50	-0.14
Japan - Nikkei 225 Index	+6.89	-11.04	-3.11	+0.92
MSCI World Sectors				
Consumer Discretionary	+12.18	-4.10	+0.06	+4.12
Consumer Staples	+11.99	+4.39	+7.10	+6.30
Energy	+14.44	-10.36	-9.66	+1.82
Financials	+8.41	-6.61	-4.09	-8.21
Healthcare	+8.14	-2.06	+9.20	+12.23
Industrials	+14.39	-4.25	+1.61	-0.62
Information Technology	+19.57	-1.59	+6.43	+12.63
Materials	+12.04	-3.55	-4.06	-2.51
Real Estate	+16.02	+10.63	+9.48	+12.94
Telecommunications Services	+11.53	+3.97	+9.77	+6.59
Utilities	+10.02	+10.52	+11.50	+14.14

Quarterly statistics

Equity Indices	3 Month % Change 31 Dec 18 to 31 Mar 19	6 Month % Change 30 Sep 18 to 31 Mar 19	9 Month % Change 30 Jun 18 to 31 Mar 19	12 Month % Change 31 Mar 18 to 31 Mar 19
Bond Indices				
Bloomberg Barclays Series-E US Govt 1-5 Yr Bond Index	+1.23	+3.00	+3.05	+3.17
Bloomberg Barclays Series-E UK Govt 1-5 Yr Bond Index	+0.56	+1.34	+1.17	+1.65
Bloomberg Barclays Series-E Canada Govt 1-5 Yr Bond Index	+1.19	+2.72	+2.59	+2.85
Bloomberg Barclays Series-E Euro Govt 1-5 Yr Bond Index	+0.44	+1.35	+0.80	+0.24
Foreign Exchange Rates				
Sterling versus US Dollar	+1.94	-0.38	-1.52	-7.42
Sterling versus Euro	+4.05	+3.13	+2.50	+1.71
Sterling versus Swiss Franc	+3.27	+1.60	-1.15	-3.30
Sterling versus Canadian Dollar	+0.01	+2.92	+0.13	-3.97
Sterling versus Japanese Yen	+2.96	-2.77	-1.53	-3.45
US Dollar versus Euro	+2.02	+3.38	+3.91	+8.97
US Dollar versus Swiss Franc	+1.31	+1.99	+0.37	+4.46
US Dollar versus Canadian Dollar	-1.89	+3.31	+1.69	+3.71
US Dollar versus Japanese Yen	+1.01	-2.41	-0.01	+4.28
Trade Weighted US Dollar Index	+0.30	+2.18	+2.33	+6.73
Commodities				
Reuters/Jefferies CRB Commodity Price Index	+8.22	-5.85	-8.30	-5.94
Gold Spot $/Oz	+0.78	+8.37	+3.15	-2.40
Silver Spot $/Oz	-2.36	+3.23	-6.13	-7.42
Brent Crude Index (London)	+26.26	-14.75	-14.92	+0.46
Crude Oil Futures (New York)	+32.44	-17.90	-18.89	-7.39

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