FFG

FORUM FINANCE GROUP

1994

MONTHLY NEWSLETTER

October 2018

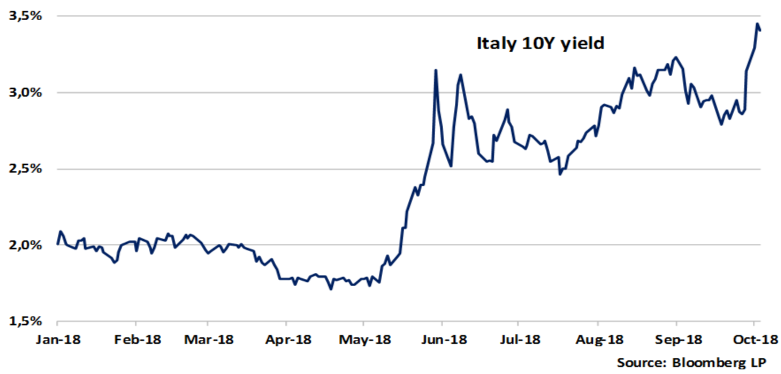
INVESTMENT PERSPECTIVE

Global equity markets ended September with modest gains following a weak start to the month. For once, Japanese equities were the outperformers while emerging market equities showed some signs of stabilisation, even if ending the month a little lower. A higher appetite for risk was reflected by the rise of the safest sovereign debt yields and a tightening of spreads for high-yield and emerging market bonds (- 38bps on the J.P. Morgan EMBI Global Spread Index). As to be expected in such a context, the Swiss franc and the Japanese yen depreciated against other major currencies.

The 3rd quarter performances of the main regional indices reflect the extent of the outperformance of U.S. equities so far this year. The S&P 500 returned 7.2%, its best quarter since the last quarter of 2013, whereas the Euro Stoxx 50 gained a marginal 0.1% and the MSCI EM lost 2%, in dollar terms. In spite of more expensive valuations, the U.S. equity market has been underpinned by an accelerating economy and the strong growth of earnings. The quarter was also notable for the fact that the broader U.S. market outperformed the mega cap tech stocks which had been leading the rally for some time.

As fully anticipated, the Federal Reserve raised its benchmark interest rate by 0.25% to 2.25% at its end-September meeting. This third hike in 2018 is widely expected to be followed by another 0.25% hike in December. The most recent comments by the bank's chairman, Jerome Powell, suggest that the Fed is far from ending its tightening cycle; Powell pointed to the fact that rates were "a long way from neutral at this point" and cited a "remarkably positive outlook" for the U.S. economy. These remarks have triggered even higher Treasury yields, with the 10-year Treasury yield trading at 3.2% at the time of writing.

THE FLARE-UP OF ITALIAN SOVEREIGN DEBT YIELDS



The recent flare-up of Italian bond yields reflects investors' concerns over the Italian budget and the much wider-than-expected deficits projected over the next years. 10-year borrowing costs have risen significantly this year, reaching their highest level since 2014. Considering the high Italian sovereign debt-to-GDP ratio, financial markets are concerned that the Italian government's plans could lead to a confrontation with the European Commission and also ultimately result into an even higher level of debt. This issue represents the biggest risk factor for European assets currently and largely explains the trend of the euro relative to other major currencies.

KEY ECONOMIC DATA PUBLISHED IN SEPTEMBER

- China's August exports rose by 9.8% (YoY) compared to expectations of + 10%; imports increased by 20%, more than forecasts of 17.7%.
- China's Caixin Manufacturing PMI declined to 50 in September, below market expectations of 50.5.
- Economic sentiment in the Euro-Zone rose in September (ZEW survey at -7.2 vs. -11.1 in August). The PMI Composite number was slightly weaker in September, at 54.2.
- In Germany, economic sentiment (ZEW survey) improved in September (76 vs. 72.6 in August). The IFO Business Climate Index was stable at 103.7, above expectations.
- US consumer confidence was 138.4 in September, well above forecasts of 132.1.
- The Markit US Manufacturing PMI Index was higher in September at 55.6, compared to forecasts of 55. In contrast, the Services PMI fell unexpectedly from 54.8 in August to 52.9.
- US payrolls in the private sector rose by 121K in September, below forecasts of + 180K.

THE SPREAD BETWEEN 10-YEAR ITALIAN DEBT AND BUNDS REACHES 3%

7.2%

THE S&P 500'S BEST QUARTER SINCE 2014

FFG

MONTHLY NEWSLETTER
October 2018

INVESTMENT STRATEGY

During the first week of October, the financial markets have been impacted by the jump of U.S. Treasury yields in the wake of strong U.S. macro-economic data and comments from Jerome Powell, signalling a potentially more hawkish stance of the Federal Reserve. Equity markets have reacted quite negatively as they reprice the impact of higher yields on valuations. At this stage, we do not think that equities are close to losing their advantage in terms of relative valuations compared to bonds. More volatility is to be expected, but the equity asset class continues to offer a much more attractive risk/return profile. As good examples, equities listed in Japan and Europe offer price to earnings (P/E) ratios for the next twelve months of 14, a theoretical long term return of 7%, compared to a yield of 0.5% on 10-year Bunds.

As rising yields impact negatively the returns of fixed-income assets, we continue to hold an underweight sovereign debt and investment-grade bonds allocation. Our preferences for the asset class are towards senior secured loans, convertible bonds and flexible strategies with the capacity to actively manage both duration and market risks.

PORTFOLIO ACTIVITY/NEWS

September was a mixed month for the portfolios. The best contribution by far was provided by Japanese equities while EM equities and the trend-following CTA strategy were the worst detractors, the latter mainly due to an extended long position in interest rates. We maintain our positive outlook on Japanese equities due to a combination of attractive valuations, shareholder-friendly measures, low investor positioning and solid earnings' growth. To a certain extent, the Japanese market also displays a lesser correlation to other developed equity markets.

In September, we took the decision to redeem a European Credit Fund because of the fund's decreasing size of assets. This exit, for a risk management purpose, is unfortunately inopportune from an investment perspective. The strategy of the fund included the hedging of duration risk, matching our assessment that sovereign yields should continue to keep on rising gradually. At the portfolios' level, it is however also important to point out that our overall level of duration risk across the fixed-income exposure is low.

THE SUDDEN RISE OF SOVEREIGN YIELDS SHAKES THE MARKETS

	End 2017	August 2018	September 2018	MTD	2018
Equities					
S&P 500	2673.6	2901.5	2914.0	+ 0.4%	+ 9.0%
Euro Stoxx 50	3504.0	3392.9	3399.2	+ 0.2%	- 3.0%
MSCI EM	1158.5	1056.0	1047.9	- 0.8%	- 9.5%
Yields					
UST 10-year	2.41%	2.86%	3.06%	+ 20bps	+ 65bps
Bund 10-year	0.43%	0.33%	0.47%	+ 14bps	+ 4bps
BBB EU	1.44%	1.66%	1.83%	+ 17bps	+ 39bps
Currencies					
EUR/USD	1.201	1.160	1.160	+ 0.0%	- 3.4%
USD/CHF	0.974	0.969	0.982	+ 1.3%	+ 0.8%
EUR/CHF	1.170	1.124	1.140	+ 1.4%	- 2.6%
GBP/USD	1.351	1.296	1.303	+ 0.5%	- 3.6%
Commodities					
CRB Index	193.9	193.0	195.2	+ 1.1%	+ 0.7%
Oil (WTI)	USD 60.4	USD 69.8	USD 73.3	+ 5.0 %	+ 21.4%
Gold	USD 1303	USD 1201	USD 1191	- 0.8%	- 8.6%