ISGAM

Manager's Report

QUARTER TO 30 SEPTEMBER 2019

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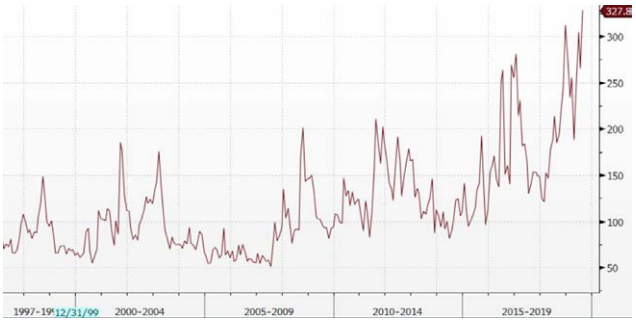
The third quarter of 2019 saw market volatility, exacerbated by the usual thin summer trading, but after a recovery in September asset prices ended the period barely changed.

The geopolitical issues that have dominated the news for most of the year (the US-China trade tensions, Brexit, increased populism, climate change) continue. In fact, both geopolitical and economic policy uncertainty have been higher this year than they have been for a long time.

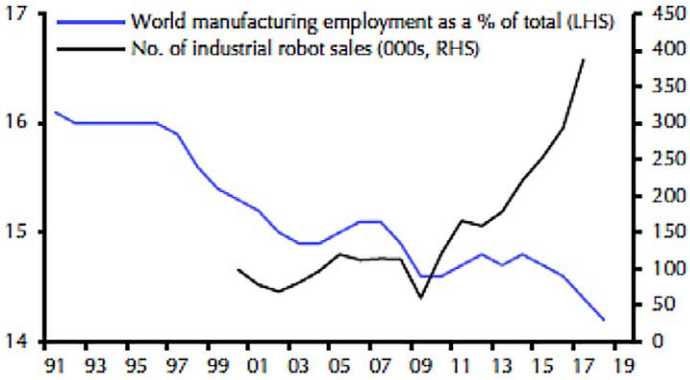
Chart 1 Global Economic Policy Uncertainty Index



Source: Bloomberg Finance L.P.

Global growth has been "syncing" lower; global manufacturing is actually in a recession which is most keenly felt in economies that are very sensitive to global trade flows (such as Germany, South Korea) and has been spreading to more "closed" and previously strong economies such as the United States, where the effects of Mr. Trump's tax cuts are wearing off. Manufacturing has become a smaller part of the global economy though; the services economy and consumer spending drive the majority of global GDP and global employment, also in developing countries, due to technological change and robotization. Just over 14% of the world's working population are employed in manufacturing these days; this figure is even lower in developed countries.

Chart 2 Global manufacturing employment shrinks as robot sales increase...



Sources: ILO, IFR, Capital Economics

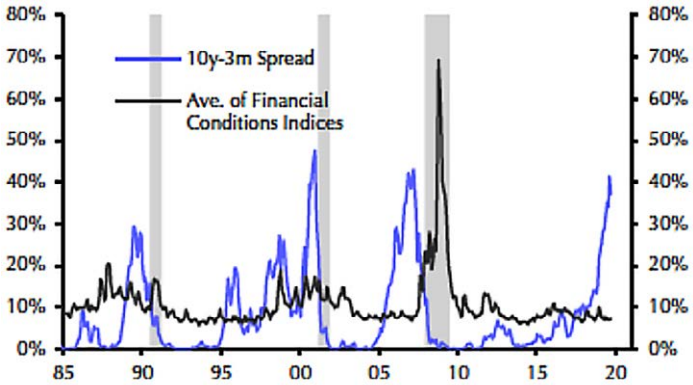
Until now, low unemployment and strong consumer spending has kept overall GDP growth positive, especially in the US. It remains to be seen to what extent the Services part of the economy will be pulled down by the weakness in Industrial Production. So far, estimates for real GDP growth have declined but remain positive for 2019; at 2.3% YoY for the US (coupled with inflation of 1.8%), 6.2% for China (inflation 2.5%), and a weak but still positive 1.1% for the Eurozone (inflation 1.1%).

The low inflation numbers enable Central Banks to provide support through renewed monetary easing; all major Central banks have moved back to an "accommodative" mode from their previous tightening plans. Global government bond yields have lurched back down towards all-time lows over the summer; the US 10-year bond yield is currently around 1.7%, the German 10-year Bund yield -0.4%, and the UK 10-year Gilt yield around 0.6%. Stocks currently yield quite a bit more than Government or Investment Grade bonds, so are relatively attractive among the different asset classes.

Economists differ on whether the current weak patch in the global economy will give way to a rebound next year, as geopolitical tensions fade and central banks provide support, or whether we are heading towards a recession.

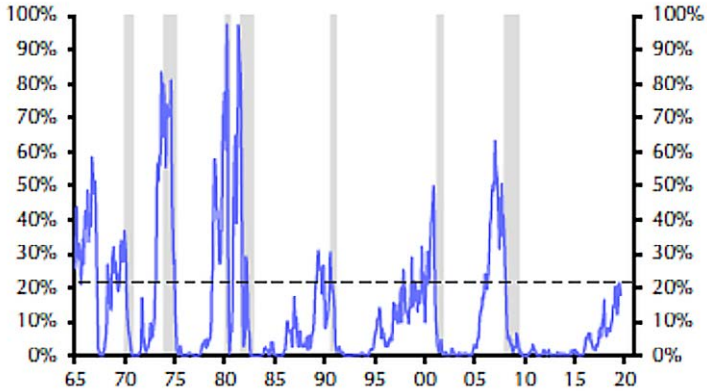
The recent "inversion" of the US yield curve (where the 10-year government bond yield temporarily dipped below short-term yields) received much attention in the press as a significant "leading indicator" of a recession. We have previously written in these reports that US yield curve inversions are historically an accurate precursor of recessions, but not a good "timing" indicator as the time lag can be long. Capital Economics' "Recession Watch" recently published two interesting graphs, one (*chart 3*) showing 2 single variable recession indicators (the "inverted yield curve" indicating a high recession probability and the overall financial conditions index a low recession probability) plus a graph (*chart 4*) showing a combination of different variables – the latter is at a level which remains inconclusive.

Chart 3 Single Variables Recession Probability – 12 months ahead (previous recessions shaded)



Source: Capital Economics

Chart 4 Composite Model Recession Probability – 12 months ahead



The main drivers of the current Industrial Production slump are uncertainties regarding:

- US-China trade tensions
- Brexit
- Japan-Korea trade tensions (less in the news)
- Looming US-EU trade tensions

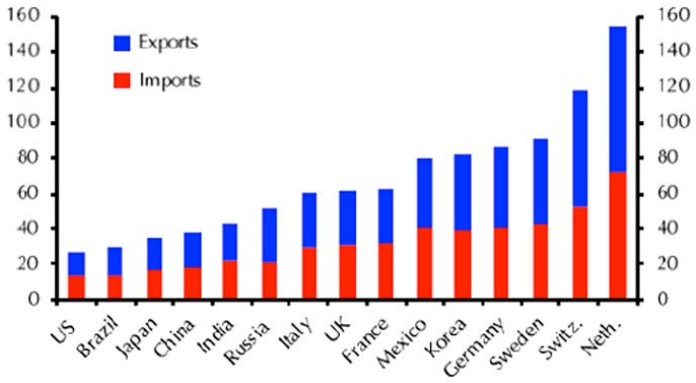
At the time of writing, there is some hopeful news regarding a potential Brexit deal; Credit Suisse has just increased the odds of the UK and the EU reaching a workable deal that passes the House of Commons (probably after 31 October) to 40%, from 15%. The pound has rallied in response, UK stocks not so much. The UK stock market currently has the highest "risk premium" of all developed markets we analyse, making them attractively valued.

What are the odds of other trade tensions dissipating soon? Unfortunately, not high. The US-China trade tensions mask a deeper power struggle, and both sides are unlikely to give in on the bigger issues (such as agreements on Intellectual Property). Meanwhile, we can expect some minor concessions to be announced from time to time as the US president is concerned that the US stock market remains strong ahead of next year's election, whilst China continues to engineer a "soft landing" for their economy. Tariffs implemented to date are unlikely to be rolled back.

So far, they have not showed up yet in the US inflation numbers; the decline in the value of the Yuan to the dollar has helped mitigate the effect of tariffs on US consumer prices.

In fact, the US economy is among those less sensitive to global trade; it is relatively "closed" in the sense that domestic spending makes up a much larger part of its GDP than trade, as per the chart above.

Chart 5 Goods and Services Trade as a % of GDP



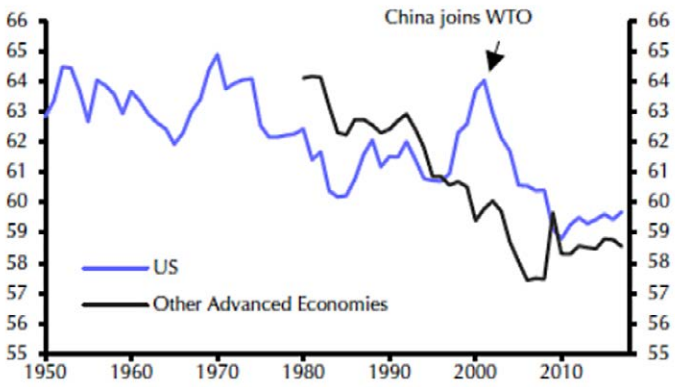
Source: Capital Economics

Indeed, the more trade sensitive economies such as Germany and Korea have seen their growth hit much harder in the past year; Germany is currently in a technical recession.

There is a good argument to be made that "globalisation" is coming to a natural end.

It has been a major driver of economic growth over the past few decades, especially in the developing world. It has also helped push down inflation in the developed world, through the integration of millions of "cheap laborers" in developing countries into the global work force. The graph below shows the effect of China's accession to the World Trade Organization on Labour's share of gross income in mature economies. The resulting decline in real manufacturing wages is probably a large contributor to the recent increase in populism.

Chart 6 Labour Share of Gross Income



Sources: St Louis Fed, Capital Economics

We recently attended a conference by Capital Economics called *"Is it the end of globalisation, and does it matter?"* They show, through a deep dive into history, how previous waves of globalisation (which they define as global trade in goods and services forming an increasing share of global GDP) always started with technological advancement, then were supported by policy. They invariably ended through changes in policy.

They then argue that the most recent wave of globalisation, which started with the tech boom and declining cost of communications and transportation in the 1990's, was already entering a period of stasis a few years before the recent US-China trade frictions. Reasons include the fact that the decline in overseas production and transportation costs have reached a natural limit, and global supply chains have reached maximum complexity.

Robotization and other recent technological advancements actually make "reshoring" of production cheaper than producing far away from where goods are consumed. As an example, Adidas increasingly uses 3D printing to manufacture shoes in the US and Germany more cheaply than using Chinese or Vietnamese labor (where wages are increasing) and then transporting the goods (which also has a larger "carbon footprint" – a factor gaining in relevance).

The future economic effects of "de-globalisation" are as of yet unknown, and will depend on which form global trade relations will take. A possible one is a "regionalisation" of trade hubs where the world splits up into separate spheres of influence, between the US, China and perhaps Europe. This might not have a negative effect, unless it is accompanied by new "technological" iron curtains. A more detrimental outcome would be a continued escalation of the trade war and tit-for-tat tarriffs.

What is our investment strategy given the current uncertainties?

Our base case scenario for the next 6 months is one of slow but positive growth, where a manufacturing slow down is balanced with continued resilience in consumer spending, supported by low unemployment and low borrowing costs. As growth will be very low, and global tensions relatively high, the "tail risks" are large, both to the upside and to the downside.

Downside risks include:

- Trade tensions boiling over
- The US Fed "under delivers" on the market's expectation of monetary easing.

Upside risks include:

- A better than expected US-China trade deal
- A better than expected Brexit deal
- Monetary easing by the Fed, ECB and other central banks takes hold
- Fiscal easing – as central banks are close to running out of ammunition the case for fiscal easing becomes more apparent, also to appease increased populism.

We stick with our slightly cautious strategy for now. Global stock markets are not cheap by historic standards (especially the US market seems fully valued in this regard) but dividend yields, earnings yields and risk premiums on stocks are quite a bit higher than investment grade bond yields or cash, so relatively speaking stocks are the most attractive asset class. Equity factors we expect to continue to outperform in this environment are quality, low volatility, growth and large cap and these remain the stock sectors we are overweight.

In fixed income, where a third of the world's bonds carry a negative yield, we continue to seek out opportunities in high yield (but relatively high quality, short duration high yield), Emerging Markets debt, and distinct areas of fixed income such as mortgage backed securities and asset backed securities.

Alternative investments we like include low-risk merger & acquisition arbitrage, global real estate, private equity, and long/short equity. We see the current (4th) quarter as having meaningful 2-way risk (to both the upside and the down side). But as we still expect the global economy to recover next year after central bank and (possibly) fiscal easing, staying the course remains the least costly option for long term investors in our view.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.

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