



Market Commentary

September 2018

**CAPITAL
TOWER**

The Right Advice At The Right Time

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My friend the communist
Holds meetings in his RV
I can't afford his gas
So I'm stuck here watching TV
I don't have digital
I don't have diddly squat
It's not having what you want
It's wanting what you've got

I'm gonna soak up the sun
Gonna tell everyone
To lighten up
I'm gonna tell 'em that
I've got no one to blame
For every time I feel lame
I'm looking up
I'm gonna soak up the sun
I'm gonna soak up the sun

I've got a crummy job
It don't pay near enough
To buy the things it takes
To win me some of your love
Every time I turn around
I'm looking up, you're looking down
Maybe something's wrong with you
That makes you act the way you do

I'm gonna soak up the sun
Gonna tell everyone
To lighten up
I'm gonna tell 'em that
I've got no one to blame
For every time I feel lame
I'm looking up
I'm gonna soak up the sun
While it's still free
I'm gonna soak up the sun
Before it goes out on me

Don't have no master suite
But I'm still the king of me
You have a fancy ride, but baby
I'm the one who has the key
Every time I turn around
I'm looking up, you're looking down
Maybe something's wrong with you
That makes you act the way you do
Maybe I am crazy too

I'm gonna soak up the sun
Gonna tell everyone
To lighten up
I'm gonna tell 'em that
I've got no one to blame
For every time I feel lame
I'm looking up

I'm gonna soak up the sun
Gonna tell everyone
To lighten up (I'm gonna tell 'em that)
I've got no one to blame
For every time I feel lame
I'm looking up

I'm gonna soak up the sun
I got my 45 on
So I can rock on

Sheryl Crow – "Soak Up The Sun"

“September tries its best to have us forget summer.”

Bern Williams

Sheryl Crow’s words remind us to bask in the moment and appreciate what we have rather than don’t have. A positive approach to all things. Yet, despite a glorious hot summer that apparently broke records, everyone’s focus will undoubtedly be on the return of rain and cooler temperatures. Just as on the UK stock market where, despite the news that the government’s finances were in surplus by £2bn last month – the biggest surplus for July in 18 years, up from a surplus of £1bn a year ago – and borrowing in the April-to-July period fell to its lowest level since 2002, we still are told that Brexit will send us off the end of a cliff and the UK is not a good place to invest.

So how does a UK Equity fund manager cope? Here is an article written by Milena Mileva of Baillie Gifford on that very subject:

“Being a UK equity fund manager may seem a somewhat depressing occupation these days. As the spectre of the country’s exit from the European Union looms large, there are plenty of doomsayers taking the view that investing money in UK stocks is a foolish thing to do. Why would anyone bother evaluating UK investment opportunities when you could invest in the innovative dynamism of certain parts of corporate America, or the allure of China’s fascinating journey to global economic dominance? Against these competing attractions, the fate of the UK PLC seems a sorry one.

“We, however, refuse to be disheartened. Rather than being dull and futile, investing in the UK market is for us a greatly rewarding exercise. This is simply because there are some tremendously exciting British businesses which we wish to help grow to become multiples of their current size in the years to come. Some of these companies might not be household names, but they are true world leaders in their fields. They have built enviable competitive positions that rivals find hard to match. They are run with ambition and a real sense of purpose, confidently unlocking large growth opportunities which often span the globe. They feed on powerful, deeply entrenched social trends and, through innovation, aim to solve some of the most intractable challenges facing the industries they operate in. We believe that these companies’ prosperity will not be easily derailed. Their

strengths and adaptability should enable them to drive their vision, even amid evidently seismic political and economic events.

“And, by continuing to be sizeable, highly committed and patient shareholders of these businesses, while acting on our client’s behalf, we have put ourselves in the privileged position of taking a disproportionate share of any future success.” Renishaw, Genus, Abcam and FDM are great examples of dynamic and entrepreneurial UK business-to-business champions which aim to dominate their global markets.

“At Baillie Gifford, we have learnt a lot by owning these great businesses and hope we can use some of those lessons to spot other big winners in the future. One of the key things we have observed is just how crucial their unusual corporate cultures have been to their excellence. This manifests itself in a number of ways.

“First, they are all united by an unwavering focus on the long term. Whilst most companies tend to pay lip service to long-termism, it seems to us that precious few have the courage to consistently follow this belief. For most, a quarter or two of weak demand or missed earnings expectations is sufficient to result in ad hoc cost cutting and various forms of financial engineering to shore up the numbers. Second, these great UK growth businesses all have strong identities and a vision which extends far beyond the imperative to generate profit for shareholders. This in turn tends to result in them having a strong alignment with their customers and employees. Take Ted Baker’s relentless obsession with the uniqueness of its product and the experience of its customers. Everything the company does is in service of this goal. We think this makes it very different to other listed retailers which can often focus unduly on store targets and building up large estates. In the words of its own eccentric founder, Ray Kelvin:

“Dominant is an aggressive word, it is just about letting it grow naturally. I don’t have a preconception of ‘in five years we will be there’ and ‘in 10 years we will be at this level’ because if you push it too hard, then the customer realises it is a forced brand. You have to nurture it and feel for it. Taking care of our customers and getting

market commentary

“Venezuela, given its extraordinary educational, cultural, and social developments, and its vast energy and natural resources, is called on to become a revolutionary model for the world.”

Fidel Castro



repeat business is the only thing we aim for.” We believe this means that, unlike many of its peers, Ted Baker is not going to be disrupted by the accelerating shift to online shopping. On the contrary, we see the company fully embracing and capitalising on these changes in consumer behaviour.

“Finally, all of these businesses realise that the only way they can achieve their long-term ambitions is by nurturing their own employees. Renishaw, for instance, faces a great challenge of recruiting enough skilled engineers in the UK. It is, therefore, well-known for taking care of its existing employees. And, through its long-standing apprenticeship programme, education outreach efforts, and comprehensive network of contacts with UK universities, it works hard to find new talent. We are equally encouraged by the great work and commitment of the FDM management team to increase the representation of women in IT, an industry where females are grossly underrepresented. Its ex-armed forces and other social inclusion and mobility recruitment initiatives are examples of the company’s efforts to ensure the sustainability of its own business, but also to contribute to positive social change.”

Well it’s certainly revolutionary – though not as Castro envisaged. Venezuelan President Nicolas Maduro carried out one of the greatest currency devaluations in history in August – a **95 percent plunge** that will test the capacity of an already beleaguered population to stomach even more pain.

One likely outcome is that **inflation**, which already was forecast **to reach 1 million percent this year**, will get fresh fuel from the measures. **Prices are currently rising at an annualized rate of 108,000 percent**, according to Bloomberg’s Café con Leche index. A massive exodus of Venezuelans fleeing the

crisis to neighbouring countries will likely increase, and with it tensions and restrictions.

The official rate for **the currency will go from about 285,000 per dollar to 6 million**, a shock that officials tried to partly offset by raising the minimum wage 3,500 percent to the equivalent of just \$30 a month. While Maduro boasted in a recent announcement that the International Monetary Fund wasn’t involved in the policies, aspects of the moves bore a resemblance to a classic orthodox economic adjustment, albeit with some confusing twists.

Maduro’s new strategy for managing the economy is a desperate response after years of disastrous policies that undercut growth, sent prices soaring and turned what had once been one of Latin America’s wealthiest countries into a dysfunctional nation that’s spawned a refugee crisis. Pressure is mounting on him to right the ship as calls for his overthrow grow six years after he took over for the late Hugo Chavez. Earlier this month, Maduro started a fresh crackdown on his opponents after a failed attempt to assassinate him using an aerial drone.

The devaluation comes at the same time the government is redenominating the currency by lopping off five zeros and introducing new bills and a name change. So instead of the new minimum wage being 1.8 million strong bolivars, it will be 1,800 sovereign bolivars. **This in a country that is the world’s 11th biggest oil producer.**

Of course, it’s not just Venezuela that has presidents under siege. President Donald Trump has hit back with a warning for Washington and Wall Street. *“I think that if I ever got impeached, the market would crash,”* Trump told Fox News in an interview that



"Our shared values define us more than our differences. And acknowledging those shared values can see us through our challenges today if we have the wisdom to trust in them again."

John McCain

aired on Thursday. "Everybody would be very poor." Impeachment proceedings could very well rattle investors. Stocks could retreat from record highs. But a crash? That sounds extreme, says everybody else.

The American economy is strong. Corporate profits are booming, thanks in large part to Trump's corporate tax cuts. And if even Trump were removed from office, a President Mike Pence would support the same pro-business policies — although maybe without the trade wars and turmoil.

"Trump isn't irreplaceable. I don't think the market would crash," said Ed Yardeni, president of investment advisory Yardeni Research. And how has the S&P reacted in recent months – by reaching new highs...

Stuffing for Turkey?

Forgive the rather media-inspired headline, but the Turkish president and country has had a sharp awakening to the global trade wars – although Mr Erdogan is not new to controversy. Much has been written about his authoritarian style, paranoid outbursts, attacks on the media, questioning of the independence of the central bank, weakening political institutions and appointing family members to government positions. And he's not the only one. Political risk is on the rise globally. There are a number of weaknesses to the Turkish economic model, especially in an environment of rising US rates. Nevertheless, a political weapon, in the form of US sanctions, was the trigger for the recent crisis.



■ A - S&P 500 TR in US [5.35%]

23/02/2018 - 24/08/2018 Data from FE 2018

"Men occasionally stumble over the truth, but most of them pick themselves up and hurry off as if nothing ever happened."

Sir Winston Churchill
(1874–1965)



Developments in Turkey have put paid to two contemporary assumptions. One, that politics isn't relevant to financial markets anymore; and two, that contagion is something of the past. Both are emerging as resurgent risks, as we exit the risk-dampening period of QE, and both are very relevant to Turkey and emerging markets generally. More precisely, the risk baton has been handed from central banks back to politicians, and rightly so, if you believe that power should be vested in elected bodies.

But do politicians have the solution? For many years, disgruntled voters responded in a passive way, generally by not voting, but as new voting opportunities arose in the form of important referendums and new leadership styles, voters have felt more empowered. In this sense, there is a new energy to politics, but politicians have much to do.

In the more fragile emerging markets, there is a growing constraint to political progress due to the economic backdrop. In the more democratic countries, politicians are increasingly dogged by formal investigations (Trump in the US) or internal tensions (the UK's two main parties, the Italian coalition, the Indonesian ruling party, etc.), reflecting a disharmony and feeding a mistrust of politicians.

Generally, there are no signs of moving towards a more harmonious political environment. The Italian bridge tragedy, far from pulling disparate groups closer, has led to heightened tensions within the coalition, and between the coalition and the EU. Maybe the passing of the US mid-term elections in November will see political tensions drop but, with few quick fixes out there for longer-term issues like inequality, it looks like the blame game is here to stay.

The survival of the fittest is becoming an increasingly dominant theme, with higher interest rates providing a less forgiving environment but, in addition, we are

starting to see a more active sanctions policy from the US, which is more effective against 'weaker' countries. This policy, alongside escalating trade tensions, reflects the US flexing its economic, rather than military muscle.

A frequently asked question is: what does this mean for markets? Markets got Brexit and the US election wrong, both the outcome and the anticipated response from markets. Meanwhile, the consensus at the beginning of this year was that a soft Brexit would be the most likely outcome and that trade tensions would abate. So far, the reverse has happened. All these assumptions have consistently and incorrectly backed the status quo.

Perhaps the lessons are that the market has been consistently behind the political curve and that history has taught us not to take conviction positions around political risk. Instead, the best option is to continue to back the stronger economies and companies, whilst ensuring that they are not exposed to high levels of debt.

SUMMARY

"Shall I compare thee to a summer's day?
Thou art more lovely and more temperate:
Rough winds do shake the darling buds of May,
And summer's lease hath all too short a date."
William Shakespeare (1564–1616), Sonnet XVIII

This month's summary of the prospects for all major asset classes is provided courtesy of Schroders Economic and Strategy Outlook for September 2018:

Equities

Strong earnings results continue to provide support for US equities. In addition, US equities also appear to be boosted by a reacceleration of share buybacks.

We continue to be cautious about Eurozone equities,

taking into account global trade tensions and tightening financial conditions.

For UK equities, political division around Brexit and higher risks of a no-deal scenario detract from UK equities' appeal.

Japanese equity valuations are attractive, but weakness in macroeconomic data and cyclical indicators point to a slowdown, which keep us neutral.

Attractive valuations for Pacific ex-Japan equities are offset by momentum indicators for China and Singapore having declined sharply in past couple of months.

Economic fundamentals for emerging markets are still intact, and we believe that we are over the worst of the sharp losses suffered in recent months.

Government bonds

US Treasuries continue to look rich against a backdrop of negative term premium, an upcoming large supply increase and higher hedged yields available overseas.

UK Gilt valuations remain expensive, but uncertainties around Brexit may delay further rate hikes by the Bank of England.

For Germany, while weaker growth has been priced, inflation risks have not. The European Central Bank remains reluctant to hike too early but isn't as dovish as the market wants to believe.

For emerging markets local currency, we remain neutral as cyclical headwinds prevent us from taking advantage of the improvement in local market valuations.

Corporate bonds

For US IG corporate bonds, both merger and acquisitions (M&A) activity and leverage continue to increase. We remain negative. US high yield bonds are the best performing market year-to-date. From a valuation perspective, we believe it is expensive and vulnerable, with technicals in particular unlikely to be as favourable in the second half of the year.

European corporate bonds are in a stronger position, though the recent pickup in M&A and shareholder activism is potentially indicative of a maturing cycle in the region. For Europe high yield bonds, political instability in the region continues to linger and is

likely to cap spread tightening, hence we retain our negative view.

Commodities

For energy, price momentum has deteriorated but oil prices should still be supported by robust global demand and the potential for political tensions in the Middle East.

We remain neutral on gold. The relationship between gold and interest rates has now normalised, but a stronger USD is a threat to the gold price.

Industrial metals have fallen sharply in recent weeks. We believe this is overdone given that the cyclical environment remains attractive. We remain positive.

The recent correction in agriculture relates to trade war concerns rather than fundamentals, so we remain positive.

Currencies

The US dollar continues to push higher, fuelled by economic outperformance vs. the rest of the world.

For UK sterling, reasonable economic fundamentals and a more assertive Bank of England are being ignored as "hard Brexit" risks are building.

For the Euro, we have been disappointed by continued weakness in European fundamentals, compounded by a resurgence in Italian political risk.

The summary from Schroders shows that there are very divergent prospects for all the major asset classes going forward. Whilst the economic back continues to remain supportive, we remain...

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