FP FINANCIAL PARTNERS

A well-oiled machine

Weekly Digest

19 November 2018

– *Richard Stutley, CFA*

Amidst all the Brexit-related headlines and discussions of trade wars, a steep decline in the oil price has gone by relatively unnoticed. Brent crude, the international benchmark, peaked at 86 dollars a barrel in October and since then has fallen back towards $65, in line with its level at the start of the year. This is good news we would argue, boosting disposable incomes for consumers which should support the current cycle, while the extent of the negative impulse from lower oil prices should be relatively limited.

Oil prices rose steadily through the first half of the year in response to falling supply from Venezuela and America's pledge to reintroduce sanctions on Iranian exports after withdrawing from the Iran nuclear deal, and took another leg up from mid-August after reports of dwindling global stockpiles. Record output from the US and Russia, America's decision to grant a temporary reprieve to importers of oil from Iran, and the impact of dollar strength on global demand for oil, has prompted a subsequent slide in prices starting in October.

Lower oil prices are clearly bad news for producers, prompting them to postpone spending on investment. Capital expenditure by energy companies in the United States is less than 10% of total capex however, and hence the impact of this foregone investment is likely to be small in comparison to the boon for consumers.

With the US economy growing at 3.5% year-on-year in the third quarter, almost 2% faster than the Eurozone, the additional procyclical impulse from lower fuel prices raises fears of overheating. However this is one area in which dollar strength is having a positive impact, as highlighted in a research piece from Deutsche Bank. While in other areas the dollar has clearly acted as a headwind to markets, not least of all in emerging markets where equities have steadily declined post January, in this case it serves to tighten US monetary conditions. This means the Federal Reserve (Fed) can continue to be measured in raising interest rates.

Fed policy remains one of the key drivers behind asset prices in this current cycle. Should the Fed be forced to raise interest rates more quickly than currently forecast and more quickly than the economy, which is still heavily laden with debt, can tolerate, this would quickly stall growth. In this scenario we would expect most asset classes to struggle, with rising interest rates prompting bond prices to fall while the deteriorating growth outlook would simultaneously weigh on equities. Dollar strength reduces the risk of the US economy overheating and the need for an aggressive policy response from the Fed.

We expect the Fed to continue increasing interest rates gradually in response to strong growth and slowly rising inflation, which should support the current cycle and equities. This is how we are positioned currently, with a meaningful allocation to equities, which now offer a better entry point following last month's falls. We are not wed to one scenario in building outcomes-based solutions for clients however, and hence alongside these positions we include a decent allocation to diversifying assets such as gold and liquid alternatives, with the aim of charting a steady course through what we expect will continue to be volatile times ahead.

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The **Marketplace**

- UK-EU agree draft Brexit deal, but UK Parliament approval in doubt
- Disappointing Q3 economic growth in Germany and Japan
- Brent crude extends its declines, down 4.9% to $66.8 per barrel
- Gold ended the week 1.3% higher at 1223.5 per ounce

Market **Focus**

US

- US Core Consumer Inflation, which excludes volatile items such as food and energy, increased by 2.1% year-on-year in October, following a 2.2% rise in the prior month and matching market expectations
- US equity markets fell in the week; the S&P 500, Nasdaq Composite, Dow Jones Industrial Average declined -1.6%, -2.2% and -2.2% respectively
- Equity market weakness and a decline in oil prices caused a flight to the perceived safe-haven of Treasury bonds during the week, with US Treasuries returning 0.7%

UK

- The UK and EU agreed on a draft withdrawal agreement – setting out the proposed future relationship between the UK and EU. However, there has been widespread criticism over the proposed deal, two of the prime minister's cabinet ministers resigned including Brexit Secretary Dominic Raab, forcing Prime Minister Theresa May to reshuffle her cabinet. There is also doubt over whether the plan can win the approval of the House of Commons
- In light of these events the overseas earnings dominated main board closed -1.3% lower, while the more domestically orientated mid cap market ended the week down -2.7%. UK Gilts returned 0.1% in the week
- Sterling weakened on Brexit concerns; depreciating -1.8% versus the Euro and -1.2% versus the US Dollar

Europe

- European markets were unsettled amid Brexit worries and the continued standoff between Italy and the European Union over Italy's budget
- The Italian government re-submitted its draft 2019 budget with unchanged budget deficit and growth projections, of 2.4% and 1.5% respectively, despite pushback from the European Commission. Italian government bond yields rose, while Italian equities fell -2.0%
- In Germany, the economy contracted 0.2% quarter-on-quarter, its first negative quarterly print since early 2015
- European equities fell -1.6% in the week

Asia / Rest of The World

- US-China trade negotiations have intensified following several telephone negotiations between senior officials in Beijing and Washington. This boosted Chinese stock markets, rallying 3.1% in the week
- Japan's economy contracted 0.3% on quarter in the three months to September 2018, following an upwardly revised 0.8% growth in the previous period and matching market expectations. Natural disasters and a decline in exports partly explain this contraction in economic growth
- Japanese equities declined -2.6% in the week
- Brent crude fell sharply in response to lower demand forecasts by OPEC combined with record supply by Saudi Arabia

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 Nov. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-1.6%	3.7%	3.6%	7.3%
United Kingdom	GBP	-1.0%	0.2%	-5.1%	-0.9%
Continental Europe	EUR	-1.6%	1.1%	-5.4%	-5.5%
Japan	JPY	-2.6%	2.5%	-8.6%	-5.5%
Asia Pacific (ex Japan)	USD	0.7%	5.7%	-12.3%	-10.0%
Australia	AUD	-2.8%	0.6%	-1.7%	0.6%
Global	USD	-1.5%	3.0%	-1.7%	1.7%
Emerging markets equities					
Emerging Europe	USD	0.1%	3.2%	-10.0%	-4.5%
Emerging Asia	USD	1.2%	6.3%	-14.0%	-12.5%
Emerging Latin America	USD	1.6%	1.8%	-3.5%	0.2%
BRICs	USD	2.5%	6.9%	-11.0%	-9.0%
MENA countries	USD	-0.7%	-0.6%	5.9%	9.6%
South Africa	USD	-0.2%	8.4%	-24.8%	-12.8%
India	USD	2.1%	6.8%	-8.5%	-3.7%
Global emerging markets	USD	1.0%	5.5%	-13.0%	-10.2%
Bonds					
US Treasuries	USD	0.7%	0.2%	-1.7%	-1.6%
US Treasuries (inflation protected)	USD	0.7%	0.0%	-2.0%	-1.2%
US Corporate (investment grade)	USD	-0.2%	-0.5%	-3.7%	-2.6%
US High Yield	USD	-1.3%	-1.0%	-0.1%	0.8%
UK Gilts	GBP	0.1%	-0.9%	-1.2%	0.2%
UK Corporate (investment grade)	GBP	-0.9%	-1.5%	-2.9%	-1.2%
Euro Government Bonds	EUR	-0.2%	-0.4%	-0.9%	-1.4%
Euro Corporate (investment grade)	EUR	-0.5%	-0.4%	-1.2%	-1.4%
Euro High Yield	EUR	-1.6%	-1.1%	-2.6%	-2.4%
Japanese Government	JPY	0.2%	0.0%	-0.2%	0.0%
Australian Government	AUD	0.5%	-0.6%	2.6%	2.3%
Global Government Bonds	USD	0.5%	-0.1%	-3.1%	-2.2%
Global Bonds	USD	0.4%	-0.1%	-3.2%	-2.3%
Global Convertible Bonds	USD	-0.4%	1.4%	-3.1%	-2.6%
Emerging Market Bonds	USD	-0.4%	0.0%	-6.7%	-5.7%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 Nov. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	0.1%	2.6%	1.2%	0.1%
Australian Property Securities	AUD	-1.6%	-0.9%	-2.4%	-1.1%
Asia Property Securities	USD	2.1%	3.8%	-7.8%	-4.9%
Global Property Securities	USD	0.1%	2.7%	-3.6%	-1.3%
Currencies					
Euro	USD	0.7%	0.2%	-5.1%	-3.1%
UK Pound Sterling	USD	-1.2%	0.1%	-5.2%	-2.8%
Japanese Yen	USD	0.8%	-0.3%	-0.2%	0.0%
Australian Dollar	USD	1.5%	3.8%	-6.1%	-3.4%
South African Rand	USD	2.6%	4.1%	-11.4%	1.2%
Swiss Franc	USD	0.5%	0.1%	-2.6%	-0.7%
Chinese Yuan	USD	0.3%	0.3%	-6.1%	-4.6%
Commodities & Alternatives					
Commodities	USD	-0.3%	-2.7%	-0.6%	3.2%
Agricultural Commodities	USD	-0.1%	-0.3%	-3.9%	-4.2%
Oil	USD	-4.9%	-13.7%	-0.2%	8.8%
Gold	USD	1.3%	-0.3%	-6.3%	-4.4%
Hedge funds	USD	-0.8%	0.0%	-5.0%	-3.7%

Source: Bloomberg. Past performance is not indicative of future returns

For more information, please contact your adviser or alternatively contact:

Financial Partners Ltd.
泛柏資產管理有限公司
Unit 01 - 03
24/F, Kinwick Centre
32 Hollywood Road
Central, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
client.services@f-p.hk
www.f-p.hk

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