Lincoln Private
Investment Office
London

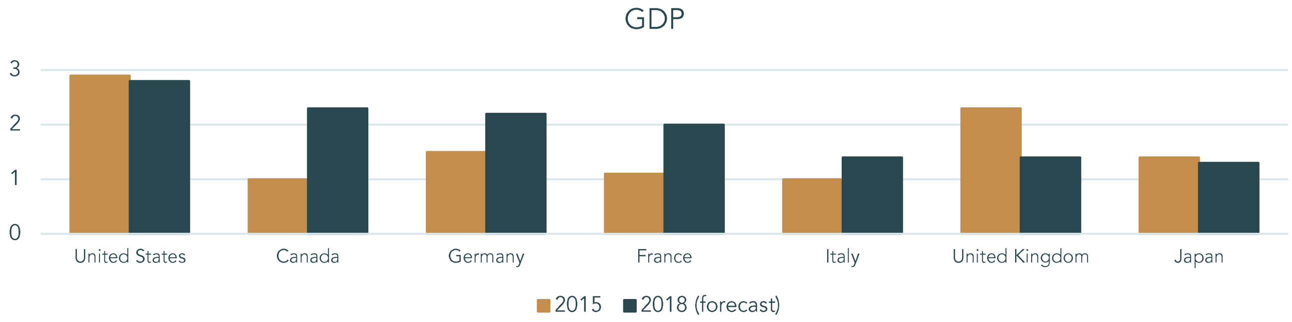
30 June 2018

# Investment Letter – Q2 2018

"In the West you have the notion that if somebody hits you on the left cheek, you turn the other cheek. In our culture we punch back". Xi Jinping, President of China, in response to the US tariffs.

Increased volatility, trade war headlines and idiosyncratic country shocks have made this year a tough one so far for markets. Index returns are in the most part negative, and the majority of fund managers have not succeeded in keeping up with their chosen benchmark. Bond and equity markets have fallen and even gold has lost value. There have however been pockets of opportunity that a number of managers, in our client portfolios, have been able to exploit.

We are 9 months away from the day that the UK is scheduled to leave the EU. Since the referendum, the UK economy has moved from a global leader to a laggard. The latest survey from Bank of America Merrill Lynch shows that the UK is the least popular country for global investors. Following what was an extremely negative first quarter for UK equities, the FTSE 100 has since managed to outperform its developed market peers, in part due to the deterioration of sterling. On a positive note, the UK's budget deficit is turning into a surplus, reporting its lowest level of borrowing in 11 years. That being said, the economic implications of Brexit seem to be weighing down the economy, unfortunately proving to be more of an ongoing ache and less of a short, sharp sting. The chart below shows how UK GDP has slowed significantly since 2015.




Source: The Economist, 2018

From a global perspective the last quarter was filled with additional risks. America imposed further financial sanctions on Russia because of their "malign activity" abroad. Geopolitical tensions between the two countries rose and the Russian stock market fell sharply as investors rushed to the exit. In May, Argentina took over the headlines. In an attempt to save its currency, which has fallen in value by 55% this year, Argentina increased its interest rates from 27.25% to 40%. Then came the Brazilian truck driver strike, where hundreds of thousands of drivers protested over fuel prices for 10 days, costing the country 0.8% of GDP. These events, alongside a strengthening dollar, drove negative sentiment to other Emerging Market currencies, causing them to fall dramatically. We took advantage of the opportunity to increase our position in Emerging Market Bonds, believing the longer-term fundamentals to be sound. With only 14% of Emerging Market Bonds denominated in dollars, the asset class is now much less sensitive to external shocks than they have been historically.

Fears over Italy arrived at the end of May when the populist parties hired a Eurosceptic, Paolo Savona, as the finance minister. The Italian President subsequently vetoed this appointment, hoping to demonstrate Italy's commitment to Europe. However, these actions highlighted how dysfunctional Italy's political system is, and so with worries of an economic crisis growing, both bonds and equities fell dramatically. When the short-term fears subsided, concern turned to Italy's long-term anaemic growth and high debt levels. It has the largest public debt in Europe and the 4th largest in the world at €2.3 trillion. With an economy ten times bigger than Greece, Italy is too big to fail but also too big to bail.

Trade war fears are high following the implementation of initial tariffs by the US in an attempt to reduce their trade deficit. Protectionism is returning, exposing industries to new winners and losers, and if history is anything to go by, there will be more of the latter. The main focus of attention has been China. The US is imposing a 25% tariff on up to $50 billion of Chinese imports to be implemented at the beginning of July. Following retaliations, Trump has threatened to increase this to $400 billion worth of goods. This means that if all of the protectionist threats are actioned, then almost 25% of all goods imported to the US would be subject to higher tariffs. The implementation of these tariffs has caused Europe, Mexico and Canada to step in and the North American Free Trade Agreement is increasingly at risk.

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Trump views the graph below as the factual deficit the US has with China, reaching $375 billion in 2017. In reality, it is not as clear cut because trade deficits are difficult to calculate and data can therefore be misleading. If we look at Apple's iPhone; displays are manufactured in South Korea, processors come from the US, and fingerprint sensors are made in Taiwan. As a result of the final assembly taking place in China, the total import cost is recorded against China. Another issue with the data is that it ignores trade in services. Whilst it is not as significant in size as the trade in goods, the US runs a large and growing surplus with China in services. This surplus has increased significantly in the last 10 years. Finally, the widening trade gap ignores the resultant benefits. Trading with China has meant that the US can focus efforts towards higher value-added activities. By importing low value-added goods from China, they can instead focus on increasing productivity in areas such as technology. The benefits these bring to consumers are difficult to measure and so are often ignored.


Source: Census, 2018

The effects of tariffs can be unusual. One study shows that in the US 140,000 people are employed in the steel industry, but 6.5 million people are working in jobs that consume steel. Chinese exports to the US cover a huge range of consumer goods and, as a result of the tariffs, American consumers will suffer higher costs on many of these products, almost certainly resulting in higher inflation and lower efficiency.

The Chinese are responding with tariffs of their own. Whilst they have lower capacity to do so because they import less from the US, they have the advantage of a strong central government. As President Xi Jinping stated, the Chinese are not afraid of a fight. It is not straightforward though because China cannot afford lower trade and lower growth at this point in its economic expansion. They do have options however; they could reduce the number of Chinese students studying in America, and lower the number of Chinese tourists visiting America, both of which are a significant benefit to the US. In addition, many US firms operate in China which could be targeted in retaliation. China has also focused on depreciating its currency. Since talks of trade wars, China's Renminbi has fallen 6% versus the dollar, making each import the US buys that much cheaper and so reducing the impact of the tariffs. While we cannot predict the end game of the trade tit for tats, what we can be sure of is they will have a negative impact on the world as a whole.

In spite of all the trade drama, world GDP remains strong and healthy. US inflation is ticking upwards, and unemployment continues to fall. Tax cuts in the US are helping to buoy the market and if this continues until the 22nd August, it will be the longest bull market ever for the S&P 500. The main drivers of performance are the technology stocks. With interest rates rising in the US, and 2 further increases expected this year, fixed income could quickly become more attractive than equities. For the first time in 10 years, the 3 month yield on Treasury bonds in the US is higher than the yield on the S&P; the gradual move back to normalisation is at least beginning in the US.

A positive consequence of increased volatility is the rise in investment opportunities. As high conviction investors we have been able to position ourselves to benefit from the movements in the market. Conventional bond investors have had a tough year, but our unconventional stance has provided positive returns. In equity markets, our selection of alternative managers willing to hedge some of their positions has been rewarding for elements of client portfolios. We remain very focused on each holding and while we continue to want to hold funds for a long period of time, we are not afraid to make changes when we believe it is right to do so.

Fred Hervey
Chief Investment Officer