Butterfield

Investment Review

2nd Quarter 2019

Summary of markets and outlook

The longest expansion ever

As we pass the halfway point of the year, we also pass another important milestone—as, based on the data available today—this is now the longest US economic expansion in history. This period of economic growth has now entered its 121st month, which means that it has surpassed the previous record, set during the 1990s. It is therefore unsurprising that the most recent Merrill Lynch Fund Manager Survey suggests that close to 90% of managers believe that we are now in the latter stages of the current economic cycle. It is also unsurprising that this belief has prompted economists to review the question "do economic cycles die of old age?"

Our strong belief is that cycles end due to economic or financial market imbalances, exogenous shocks or because monetary policy becomes too restrictive (interest rates are raised too high). There are some who believe that the Federal Reserve always brings economic cycles to an end by overtightening policy; this is frankly a silly accusation, because it suggests that it is possible for cycles to continue forever, which is incompatible with historical precedent. What is less controversial is that the longer an economic cycle is, the more opportunity there is for economic or financial imbalances to build up in the system.

While it has been the longest economic expansion, it has also been one of the shallowest. This is largely a function of the depth of the previous recession and the pain experienced during the recession and its aftermath. Furthermore, it is no coincidence that two of the weakest sectors in the crisis—the consumer and the banking system—are in significantly better shape now than they were then. On aggregate, consumers have been reluctant to borrow and banks are considerably less leveraged than they were last cycle. Healthy consumer and banking sectors are important pillars for economic growth, so this helps to explain why the last recession was so deep. That these sectors are fundamentally healthier means that they are highly unlikely to cause the cycle to end anytime soon.

There are, however, new areas of risk, and towards the end of the cycle it is particularly important to try and understand where these might be. While the consumer and banking sectors are in much better shape, we have seen notable rises in both government and corporate debt. The capacity of the government to borrow is a subject of much debate and new theories like "modern monetary theory" are challenging the conventional thinking. The more likely vulnerability is in the corporate debt market, so this is an area where we have been spending time recently, but broadly speaking our exposure is in very high quality bonds relative to the overall public and private universe. The most likely exogenous shock appears to be trade policy, however the latest signs here are more encouraging, with the US and China appearing to reach a truce, for now, at the latest G-20 meeting in Japan. So overall, it is now 121 months and counting.

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Fixed Income

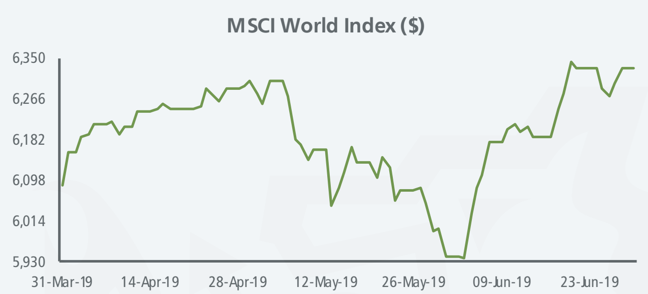
The second quarter was another very strong one for fixed income markets, with sovereign yields falling across the maturity spectrum and credit markets also performing well. In the first half of this year, the broad-based US aggregate bond index produced the best six month return (6.1%) since 2011, when yields fell as the market embraced the "new normal" idea that bond yields would be structurally lower than the past. The cause this time around is similar, in the sense that markets have rapidly re-priced the expected path of future interest rates.

We began the year with the Federal Reserve walking back their December rate rise, with a marked shift in language focusing on "patience", "downside risks" and "listening very carefully" to signals from financial markets. As we progressed through the second quarter, the market went further and aggressively priced in a series of rate cuts in the second half of this year, to the point where the market is now pricing in four rate cuts over the next twelve months. This has put the Fed in a difficult position; either acquiesce to the market and deliver the rate cuts while running the risk of asset bubbles, or don't deliver the rate cuts and run the risk of tightening financial conditions and ending the economic cycle. With the Fed under increasing political pressure, it is unsurprising that they seem to have chosen the former, with Fed Chair Jerome Powell recently stating that the Fed will "act as appropriate to sustain the expansion".

One of the key questions at this point is whether this is the start of a new rate cutting cycle or whether rate cuts would be more like "insurance" cuts, which would help boost growth and prolong the expansion, before potentially leading to rate hikes re-commencing next year. It is useful to draw on historical comparisons, as there are examples of both in the past, with very different outcomes for bond and equity markets. In both 1995 and 1998, the Federal Reserve cut interest rates by 0.75%, essentially easing policy before there was clear evidence of material economic deterioration. The 1998 comparison is probably the most appropriate, as weakness in the rest of the world, particularly in Emerging Markets, threatened to feed back to US growth through weaker financial markets. Ultimately this halted the dollar's rise, allowed growth to stabilise and risk assets then went on to make significant new highs.

We have given up a little performance from our short duration stance, but more than made up for this with our yield curve positioning, credit exposure and emerging market debt exposure. The dollar weakness seen in June was very positive for Emerging Markets, with local currency bonds having their best month since 2016. With markets pricing in a more aggressive path of rate cuts than we believe warranted by the fundamentals, we remain underweight duration. One of the risks to this view is that even with the move that we have seen in bond markets, speculative positioning has not become stretched. This could mean that yields move even lower if we get a risk-off episode in equity markets, but overall we feel that risk is better taken in selective parts of the credit market.

Summary of markets and outlook



Equities

Global equity markets continued to march higher in the second quarter, despite a setback in May. The MSCI World index returned +4.0% for the second quarter of 2019, with all major sectors and regions posting positive returns except the energy sector. It is evident that the equity market is painting a much brighter picture than the bond market. It is also a common belief that bond markets have higher predictive ability relating to future economic activity. We believe, however, that both markets are sending valid signals, at least in the near term. There are risks on the horizon in equity markets, including slowing global growth and geopolitical noise. However, equity market fundamentals are solid and there is potential for cooling tensions on the trade front as we near an election cycle in the US. Furthermore, financial conditions in the majority of developed markets, including the US, remain accommodative, reinforcing our neutral stance towards the asset class.

Following a difficult period in May, equity markets rebounded solidly in June. European and US stocks both posted strong returns for the second quarter, +5.5% and +4.2%, respectively. The majority of the return experienced so far in 2019 has been driven by multiple expansion (investors willing to pay a higher multiple of current earnings for a stock) rather than earnings growth. The S&P 500 forward multiple had fallen to a low of 14.5 times earnings in December, but is currently around 17.5.

Corporate earnings clearly slowed relative to 2018, although the slowdown is not wholly unsurprising given that the Tax Cuts and Jobs Act of 2017 skewed 2018 earnings higher. First quarter 2019 earnings were expected to fall year over year, yet finished mildly positive, but estimates of second quarter earnings remain negative. A theme coming into 2019 was the divergent nature of the first half relative to the second half of the year; this is the case with earnings expectations, as all of the growth in S&P 500 earnings was expected to come from the second half of the year. Therefore, the continued strength in equity markets partly hinges on whether there is a re-acceleration of earnings growth—as the market is expecting—because there is limited room for the market to climb based on multiple expansion alone.

Counterintuitively, the best performing sector for the second quarter was financials, which returned 6.2%, despite falling interest rates and an inverted yield curve. The US Federal Reserve recently concluded another round of the annual stress test of 18 banks. All 18 passed, which puts each bank's financial picture through a scenario of increasing unemployment and a fall in US equity prices. Following the positive results, the Fed gave the banks the green light to distribute more funds to shareholders via increases to dividends and share repurchases. However, it should equally be recognised that the Financials sector covers a lot more than just banks, and the strong performance of the sector was driven largely by improvements in equity market-sensitive parts of the industry, such as capital markets businesses and insurance.

A topic that has been commanding a lot of airtime recently is the question of international equities relative to US domestic equities. There is a belief that an agreement on the trade front will have an

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outsized positive effect on European and Asian equity markets as those are the markets most exposed to trade related factors, and those markets have struggled to keep pace with the strength of US equities since the beginning of the trade war. We continue to monitor this closely, but before we were to consider implementing this within portfolios, we would like to see a pickup in global growth levels, a missing ingredient. Until such time, we continue to have a neutral stance towards the equity asset class, as well as to all major regions.

Summary of sector views

1 Max underweight | 2 Underweight | 3 Neutral | 4 Overweight | 5 Max overweight

Consumer discretionary	2	**Underweight**: The sector performed well early in the business cycle, but as we near the latter part of the current cycle, it is prudent to trim exposure. Rising interest rates will begin to hurt the consumer in the form of higher mortgage, credit card, and student loan repayments. There is also a coming liquidity crunch in the retail sub-sector, with debt maturities increasing relative to the past five years. The sector has performed in line with the broad market over the past year, but excluding the impact of Amazon's strong performance, the sector is underperforming the MSCI World. We strive to maintain a less-than-benchmark exposure to the sector, whilst having a neutral, or overweight, exposure to large and structurally important companies such as Amazon.
Consumer staples	3	**Equal weight**: The sector is trailing the broad market year to date, but proved to be resilient during the recent market sell off. US consumer sentiment remains positive as the unemployment rate remains low and wage growth continues ahead of inflation. However, with slower global expansion and the risk of a recession increasing, the defensive characteristics of the sector should help buoy portfolios during risk-off trading.
Energy	3	**Equal weight**: Having enjoyed a relatively positive start to 2019, concerns about potentially slower growth in the global economy, and China in particular, again resurfaced during Q2. Against this backdrop, the Energy sector's cyclical characteristics saw both oil prices and stocks within the sector under pressure during most of the last quarter, before recovering during June, as geopolitical tensions between Iran and the US saw oil prices move higher on increased concerns of supply disruptions. At a corporate level, strong capital discipline and improving free cash flow generation remain positive drivers, but with global oil demand's close correlation to GDP, we remain neutrally positioned until a clearer picture of demand growth emerges that's sufficient to underpin sustainably higher longer-term oil prices.
Financials	3	**Equal weight**: The sector has performed strongly over the most recent quarter, unwinding some of the weaker performance seen in recent times. As the Fed has pivoted from tighter monetary policy to the potential for easier conditions, performance in the sector has transitioned from the interest rate-dependent banking businesses to broader financial business lines and insurance. From a valuation perspective, the sector remains cheap, both on an absolute basis and relative to the broader market, which we believe offsets the weakening fundamental picture of slowing growth and finer margins. This sees strategy maintain a neutral allocation at present, with a broad split across all financial businesses, but with an ongoing focus on the US, where economic conditions are generally seen as less challenged.
Health care	4	**Overweight**: Drug pricing pressure and political agendas have contributed to a rise in volatility within the sector over recent months, however, strong earnings growth and positive long-term secular trends remain in place. In the US, political discussions continue regarding the future shape of the US healthcare model, yet evolving demographics in both developed and emerging economies will continue to underpin demand for treatments for chronic conditions arising from lifestyle choices and aging populations and, with greater affluence in developing economies driving demand for newly affordable healthcare solutions, we retain our overweight sector stance.

Summary of sector views

1 Max underweight | 2 Underweight | 3 Neutral | 4 Overweight | 5 Max overweight

Industrials	4	**Overweight**: The sector has performed surprisingly well given the weakness in the global manufacturing sector. We expect activity to stabilise later this year, which should further support the sector. Aerospace & Defense has benefitted from rising defense spending and increasing commercial aircraft penetration globally. Protectionism is a threat to the sector, but this risk is partly reflected in valuations and we seem to have a truce, for now, in the US-China trade tensions.
Information Technology	3	**Equal weight**: Despite slowing growth in the US and China, the sector has produced strong results during Q2. Ongoing noise around trade tariffs seems to be moving towards a potential resolution, semi-conductors appear to have turned a corner and the initial shock of declining smartphone sales is subsiding. Capital spending by companies on IT is set to continue and we will see further investment in cloud and artificial intelligence technology across the globe over the next decade. Company balance sheets and strong cash flows will enhance shareholder returns, and we expect further share buybacks to complement this.
Materials	3	**Equal weight**: The metals and mining sub-sector has performed well as the construction sector in China has remained strong and the iron ore market has been supported by a favorable supply/demand balance. Some commodity markets continue to work off a long period of oversupply, but company balance sheets are in much better shape than they were. The Chemicals industry has seen an increase in M&A activity, which has supported stock prices. Attractive valuations and a continued focus on cost cutting within the sector lead us to maintain our equal weight stance.
Real Estate	3	**Equal weight**: The sector looks expensive based on an adjusted "funds from operations" yield relative to history, but looks close to fair value based on NAV and in relation to broad equities. The sector benefits from a favourable cyclical backdrop (with the exception of retail malls), but the tailwind from falling bond yields is probably abating for now.
Communication Services	2	**Underweight**: The sector has largely kept pace with that of the broader market in 2019 aided by a benign competitive landscape relative to previous years. We remain underweight the sector as concerns around privacy regulation and anti-trust legislation surrounding industry heavyweights linger. Looking further ahead, the sector should benefit from several long-term secular trends such as the next generation of 5G wireless broadband, the exponential growth in streaming video content online, and in Google's case, Cloud computing.
Utilities	2	**Underweight**: While the Federal Reserve has given a clear signal that interest rates are likely to be cut over the coming quarters, we believe our underweight stance remains appropriate. Real growth continues to be stable, while inflationary pressures that are currently muted provide the Fed additional accommodation. However, in this new regime of permanently low interest rates, the current focus on anticipating future rate movements continues to overshadow the increasing emphasis on necessary infrastructure and environmental investments, which require large capital expenditure overseen by significant regulation.

Quarterly statistics

Equity Indices	3 Month % Change 31 Mar 19 to 30 Jun 19	6 Month % Change 31 Dec 18 to 30 Jun 19	9 Month % Change 30 Sep 18 to 30 Jun 19	12 Month % Change 30 Jun 18 to 30 Jun 19
Global				
MSCI World Index	+4.00	+16.98	+1.29	+6.33
MSCI World Index (Sterling)	+6.44	+17.45	+4.05	+10.51
MSCI World Index (Euro)	+2.74	+17.94	+3.56	+9.31
MSCI Emerging Markets Index	+0.61	+10.58	+2.33	+1.21
United States				
Dow Jones Industrial Average	+3.21	+15.40	+2.34	+12.20
S & P 500 Index	+4.15	+18.18	+2.04	+9.75
NASDAQ Composite Index	+3.87	+21.33	+0.34	+7.78
Europe				
Continental Europe - Dow Jones Euro Stoxx 50	+5.48	+18.32	+4.75	+5.12
France - CAC Index	+6.19	+20.41	+4.09	+7.58
Germany - DAX Index	+7.57	+17.42	+1.24	+0.75
Switzerland - SMI Index	+6.54	+21.22	+12.43	+18.81
UK - FTSE 100 Index	+3.33	+13.14	+2.23	+1.56
Far East				
Asia - MSCI Asia Pacific Index (US Dollars)	+0.83	+10.55	-1.57	-1.08
China - Shanghai Composite	-3.62	+19.45	+5.58	+4.62
Hong Kong - Hang Seng Index	-0.16	+12.66	+5.08	+2.34
Japan - Nikkei 225 Index	+0.57	+7.50	-10.53	-2.56
MSCI World Sectors				
Consumer Discretionary	+5.35	+18.18	+1.03	+5.42
Consumer Staples	+2.77	+15.09	+7.28	+10.07
Energy	-1.56	+12.66	-11.76	-11.07
Financials	+6.16	+15.08	-0.85	+1.81
Healthcare	+1.50	+9.76	-0.59	+10.84
Industrials	+4.75	+19.82	+0.30	+6.44
Information Technology	+5.87	+26.60	+4.19	+12.68
Materials	+4.74	+17.35	+1.02	+0.49
Real Estate	+0.51	+16.62	+11.20	+10.04
Communication Services	+4.44	+16.48	+8.59	+14.64
Utilities	+2.53	+12.80	+13.32	+14.31

Quarterly statistics

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Bond Indices				
Bloomberg Barclays Series-E US Govt 1-5 Yr Bond Index	+1.86	+3.11	+4.91	+4.96
Bloomberg Barclays Series-E UK Govt 1-5 Yr Bond Index	+0.35	+0.92	+1.70	+1.53
Bloomberg Barclays Series-E Canada Govt 1-5 Yr Bond Index	+0.55	+1.75	+3.29	+3.15
Bloomberg Barclays Series-E Euro Govt 1-5 Yr Bond Index	+0.62	+1.06	+1.97	+1.42
Foreign Exchange Rates				
Sterling versus US Dollar	-2.29	-0.40	-2.66	-3.78
Sterling versus Euro	-3.51	+0.40	-0.48	-1.10
Sterling versus Swiss Franc	-4.14	-1.00	-2.60	-5.23
Sterling versus Canadian Dollar	-4.29	-4.28	-1.50	-4.16
Sterling versus Japanese Yen	-4.84	-2.03	-7.47	-6.30
US Dollar versus Euro	-1.23	+0.81	+2.20	+2.72
US Dollar versus Swiss Franc	-1.89	-0.60	+0.06	-1.52
US Dollar versus Canadian Dollar	-2.05	-3.90	+1.19	-0.40
US Dollar versus Japanese Yen	-2.61	-1.62	-4.95	-2.62
Trade Weighted US Dollar Index	-1.32	-1.02	+0.83	+0.99
Commodities				
Reuters/Jefferies CRB Commodity Price Index	-1.48	+6.62	-7.24	-9.66
Gold Spot $/Oz	+9.07	+9.91	+18.19	+12.50
Silver Spot $/Oz	+1.26	-1.12	+4.53	-4.94
Brent Crude Index (London)	-2.36	+23.28	-16.76	-16.94
Crude Oil Futures (New York)	-2.78	+28.76	-20.18	-21.15

Disclaimer

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