S U N A R E S

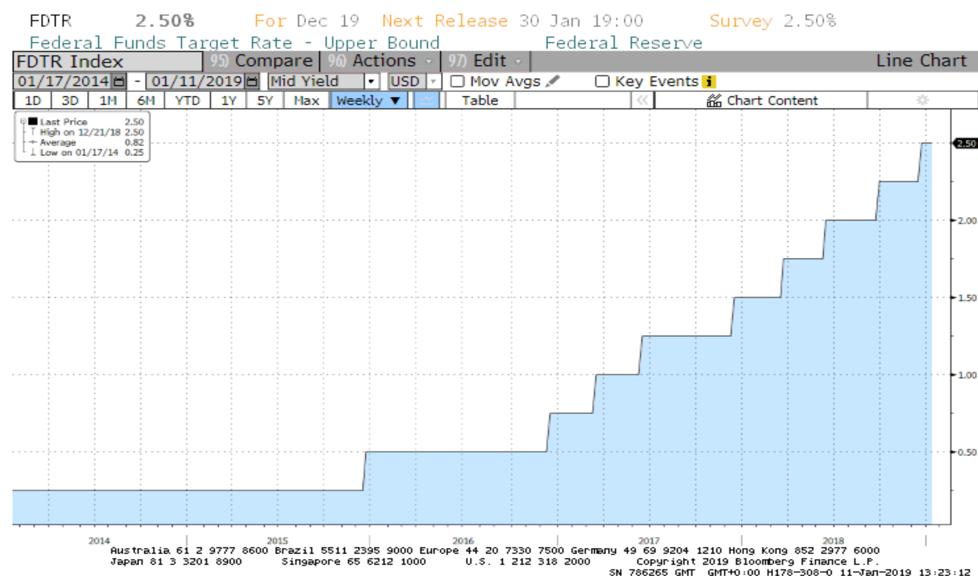
SUSTAINABLE NATURAL RESOURCES FUND

THE SUNARES REPORT
January 2019

ISIN: LU0344810915/ WKN: A0ND6Y/ BLOOMBERG: SUNARES LX / WWW.SUNARES.COM

SUNARES REPORT JANUARY 2019

A general slump in market prices and volatility testified to sudden market nervousness in the last quarter of the year. December 2018 was the worst 'stock market December' since the Great Depression of 1931, symbolizing the deterioration in financial market sentiment. Having shifted interest rates higher from the exceptionally low base of 0.25% at the tail end of 2015, the Federal Reserve began to prepare the markets for further rate hikes. This is the normal path for a central bank to take when an economy is doing well, and higher interest rates are meant to cool business activity to keep the economy from over-heating and bringing inflation. However, in this rate cycle, it has always been the case that the central bank has wanted to create firepower for when the next recession arrives. Hence the reasons for all the talk about normalising rates and bringing them back to “neutral” and at a level high enough to allow rate cuts to take place and give a future weakening economy monetary support. The chart below shows the path taken so far, starting slowly and then regular increases.



Fed Funds Rate 5-year chart. Source: Bloomberg

It should be borne in mind that the real level of interest rates was in fact far below the official Fed Funds Rate of 0.25%, because of the enormous quantitative easing (QE/ money printing) that effectively pushed the cost of money into negative territory – the so-called shadow rate. This is estimated by some to have reached a negative shadow rate round minus 2.5% to minus 3%.

This shadow rate started to adjust towards zero in the latter part of 2014, prior to actual rate increases, because the Federal Reserve announced the end of quantitative easing (QE), and Janet Yellen, the then head of the central bank, began to talk about “forward guidance” and rate increases.

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This means that the Fed has been on an upward path of rates for longer than the increase in the headline Fed Funds Rate - more than four years. Usual rate cycles have averaged 2 years and travel 3 percentage points. If we consider this cycle and the shadow rate, the move is both longer in time and magnitude i.e. from minus 2.5% to plus 2.5% for a 5% move.

Albert Edwards, the market strategist at Société Générale said:

"It is therefore reasonable to argue that the U.S. has already faced a "normal" tightening cycle and any additional rate hikes are taking us into territory not seen in recent times. This already may be enough for the Fed to have broken something."

It should also be noted that the US central bank is reducing its balance sheet at the same time as they have been raising interest rates, thus reversing QE with quantitative tightening (QT). The balance sheet is being reduced by approximately US$50 billion every month.

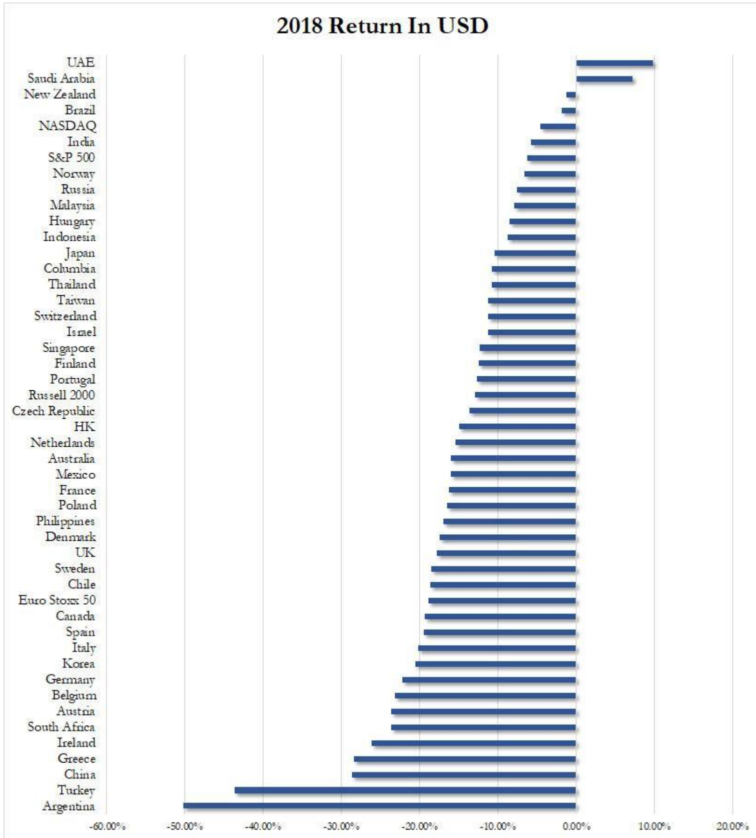
In the ten years since the great financial crisis, there has been plenty of bold talk about reducing global debts, controlling government spending via austerity budgets and generally reigning in uncontrolled spending. The reality has been very different, with debt levels increasing substantially across government, corporate and the private sectors. A recent study released by the Institute of International Finance (IIF), reported that total debt held by economies it tracks (both mature and emerging) rose to a record US$247 trillion in the first quarter of 2018. This is an increase of 11% over the same period in 2017. It is important to understand that this additional debt had very little positive impact on the world economy; indeed, it required a record US$8 trillion of freshly created debt to create just US$1.3 trillion of global GDP.
In the US debt as a proportion of GDP is also expanding and stands at some US$21.6 trillion, more than US GDP itself. The surprise is that this level of debt exists after 9 years of expansion, although growth has been tepid at best. In concrete terms the US has just over US$71 trillion in debt, which encompasses everything from car loans, student debt, credit card debt and US Treasury bonds etc. This means that every increase of 1% in interest rates gives rise to additional interest payments of US$700 billion. This is substantial and has an impact on spending in the economy and it is easy to see how rate increases bring about slowdowns. If you view rate rises in this context then it is obvious why the central bank has every reason to want to restrict rate increases.

DECEMBER ITSELF

The end of year dramatic sell-off was significant in terms of both magnitude and velocity and such moves can drain confidence from the markets very quickly. The passion for index funds and passive investing means that many investors are ill-informed and have very little understanding of the instruments they own, which means that they are prone to panic-selling. Price moves can also be exaggerated in the era of computer-driven trading. A manifestation of the trend towards passive exchange traded fund (ETF) investing is the insane proliferation of indices that are being created. There are around 50,000 listed companies traded on exchanges around the world but there are approximately 3.7 million indices! Bloomberg reported that around 438,000 new indices were brought to life in 2018 created by the likes of S&P Global, MSCI and the FTSE Russell. The reason for this is simple as the creators licence the use of their indices/ benchmarks for a fee, generating around US$2 billion in revenue last year. There is no talk of value or looking at fundamental company data and selling takes place based purely on price.

Whichever asset class we look at, everything is priced based on interest rates and having become accustomed to rates close to zero (or negative), prices have now had to adjust to higher rates. The following shows a wide range of asset classes and indices (!) and their performance in 2018:

The following items show graphically the performance across a wide range of asset classes in 2018 in US dollar terms.



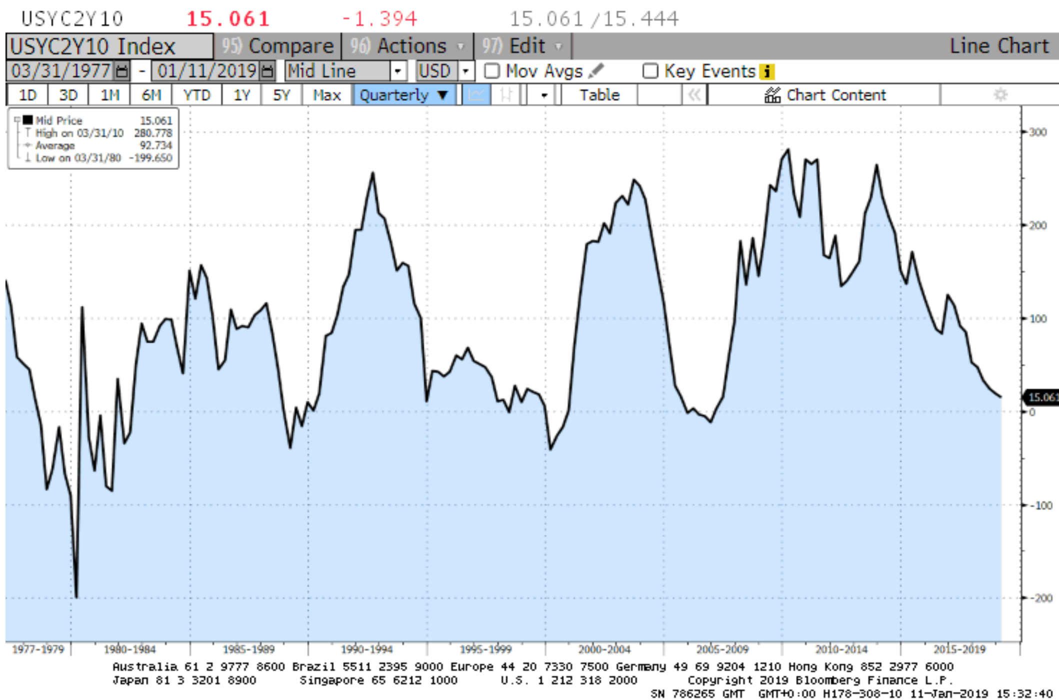
Asset class and market performance 2018. Source: Zerohedge and Deutsche Bank

We have been uncomplimentary about Federal Reserve policy vis-à-vis interest rates, but we should point out that they have also managed to halt the increase in longer-term interest rates reflected in US bond yields. We have spoken previously about the long-term downward channel of bond rates (yields) and that an increase in the 10-year bond yield over 3% is a break of this channel downtrend.

US Treasury 10-year bond yield 1989 to 11 January 2019. Source: Bloomberg

US Treasury 10-year bond yield 1962 to 11 January 2019. Source: Bloomberg

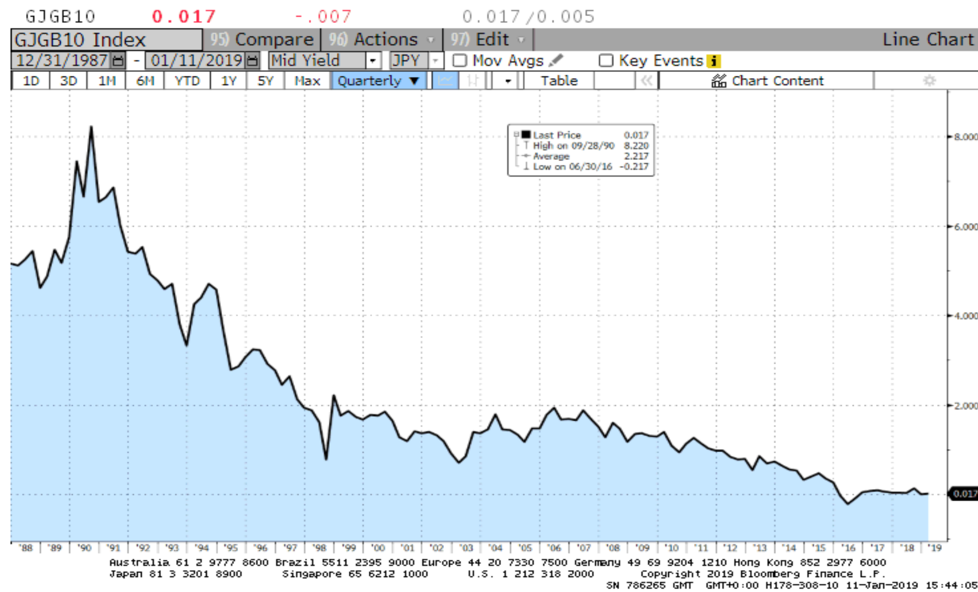
The recent rate rise has been seen as heralding a recession with indicators like the interest rate differential between the 2-year and 10-year bond a case in point.



Yield differential (spread) between 2-year and 10-year US Treasury bonds. Source: Bloomberg

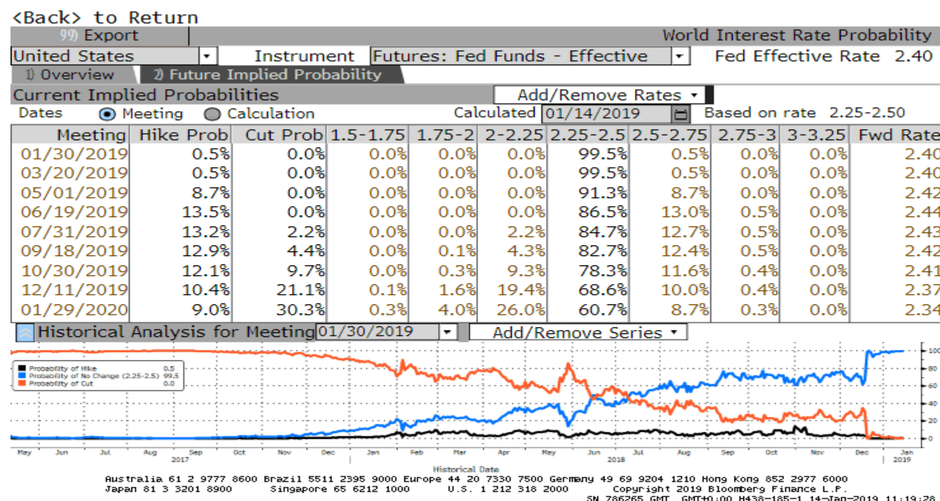
When the short-term rate (driven higher by rate increases) goes higher than the 10-year rate, it means that investors do not believe that rates will stay high for long, as the economy is not strong enough to sustain this. The bond (debt) markets dwarf equity markets and are of far greater relevance to central banks and the economy. Given the enormity of the debt pile that exists, it is essential that the yields are not allowed to run away to the upside. That simply increases the cost of capital and puts greater pressure on the central banks.

It is easy to forget that Japan has been a forerunner for the world in running with low interest rates and economic stagnation (lack of inflation and weak growth). Although it is a market controlled by the Bank of Japan and is therefore artificial (all markets are to a degree) the current 10-year bond yield is 0.017% with year-on-year GDP growth of -0.3%.



Japanese 10-year government bond yield 1987 to 11 January 2019. Source: Bloomberg

By bringing the shadow of deflation centre stage, the Fed is keeping the status quo rolling and they can be pleased with this aspect of their work. Of course, they still have to pay attention to confidence in the financial system and the value of stock markets and hence the reintroduction of a "patient" Fed i.e. rate increases are off the table for now. Markets certainly think so if the implied rate increase probability is anything to go by:


<Back> to Return
99) Export | World Interest Rate Probability
United States | Instrument: Futures: Fed Funds - Effective | Fed Effective Rate 2.40
1) Overview | 2) Future Implied Probability
Current Implied Probabilities | Add/Remove Rates
Dates: Meeting / Calculation | Calculated 01/14/2019 | Based on rate 2.25-2.50

Meeting	Hike Prob	Cut Prob	1.5-1.75	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3	3-3.25	Fwd Rate
01/30/2019	0.5%	0.0%	0.0%	0.0%	0.0%	99.5%	0.5%	0.0%	0.0%	2.40
03/20/2019	0.5%	0.0%	0.0%	0.0%	0.0%	99.5%	0.5%	0.0%	0.0%	2.40
05/01/2019	8.7%	0.0%	0.0%	0.0%	0.0%	91.3%	8.7%	0.0%	0.0%	2.42
06/19/2019	13.5%	0.0%	0.0%	0.0%	0.0%	86.5%	13.0%	0.5%	0.0%	2.44
07/31/2019	13.2%	2.2%	0.0%	0.0%	2.2%	84.7%	12.7%	0.5%	0.0%	2.43
09/18/2019	12.9%	4.4%	0.0%	0.1%	4.3%	82.7%	12.4%	0.5%	0.0%	2.42
10/30/2019	12.1%	9.7%	0.0%	0.3%	9.3%	78.3%	11.6%	0.4%	0.0%	2.41
12/11/2019	10.4%	21.1%	0.1%	1.6%	19.4%	68.6%	10.0%	0.4%	0.0%	2.37
01/29/2020	9.0%	30.3%	0.3%	4.0%	26.0%	60.7%	8.7%	0.3%	0.0%	2.34

Historical Analysis for Meeting 01/30/2019 | Add/Remove Series

Fed Funds implied probability. Source: Bloomberg

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The Fed normally hikes when there is over 70% acceptance that a hike is coming. This puts any potential rate increase out to December 2019, although this is subject to change.

The recent minutes of the December Fed meeting suggest that patience now rules monetary policy:

"...many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming."

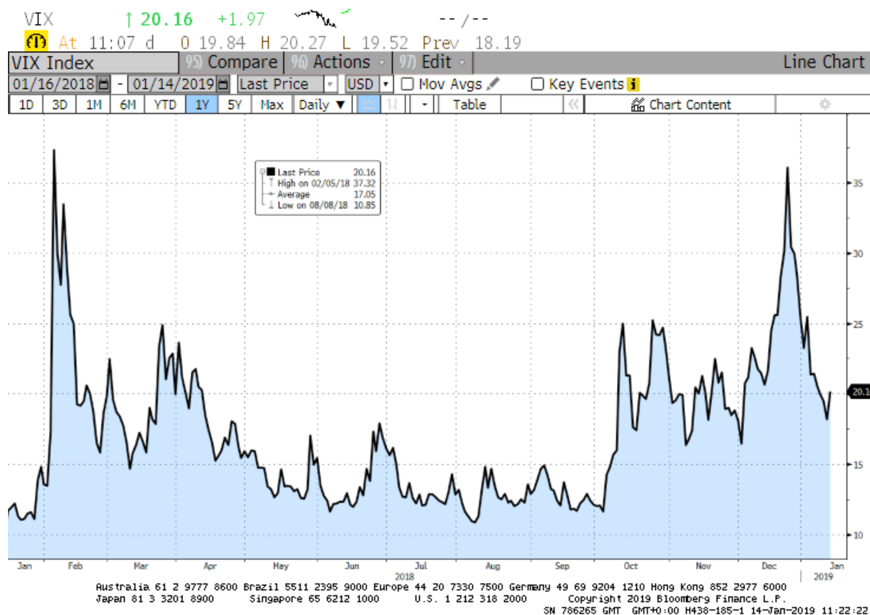
The minutes also showed that some Fed committee members are willing to *"wait and see how the data would develop amid the recent rise in financial market volatility and increased uncertainty about the global economic outlook."*

This has allowed the equity markets to stage a partial recovery although questions remain given the technical chart damage sustained in the general Q4 sell-off that accelerated in December (loss of momentum and prices moving below support levels and moving averages).

Nevertheless, there are reasons to be positive about the fundamentals of the economy and the equity market decline since the September peak appears to be a policy-driven market event rather than a credit-driven economic crisis. If we are right, then the 20% drop from equity market peaks make this the fourth non-recession crash since 1950.

The other three sell-offs took place in 1987, 1998 and 2011 and display very consistent post-crash behaviour. Once the market saw a climactic low, there was a sharp reflex rally followed by a retest of the low within 4-5 weeks, then new highs. Currently, the FTSE 100 index has rallied to the 50-day moving average and is meeting resistance at that point and the S&P500 is still below the 50-day moving average but has experienced a sharper recovery. If this follows the pattern as described above, this could mark the moment where prices make a retest of the low.

This is backed up a volatility index (VIX) that is hovering around 20. A level around 15 would be more consistent with markets that are more sanguine about future moves.



Estimate of future volatility – VIX index. Source: Bloomberg

A further market positive is that the inflation outlook remains subdued. Earnings per share (EPS) growth should slow but remain positive in 2019, with expectations for 5% S&P500 operating EPS growth.

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We think that the Fed has reacted to the market decline appropriately for now but that they may need to row back on their quantitative tightening schedule, in order to give the markets a more substantial under-pinning. There is also a need for a positive resolution on the trade tariffs between the US and China. Talks are ongoing, and more is expected when the two sides meet officially on 31st January. Both countries stand to benefit from a resolution although the details have to be ironed out. Let us hope the iron is on full steam setting to iron out any creases!

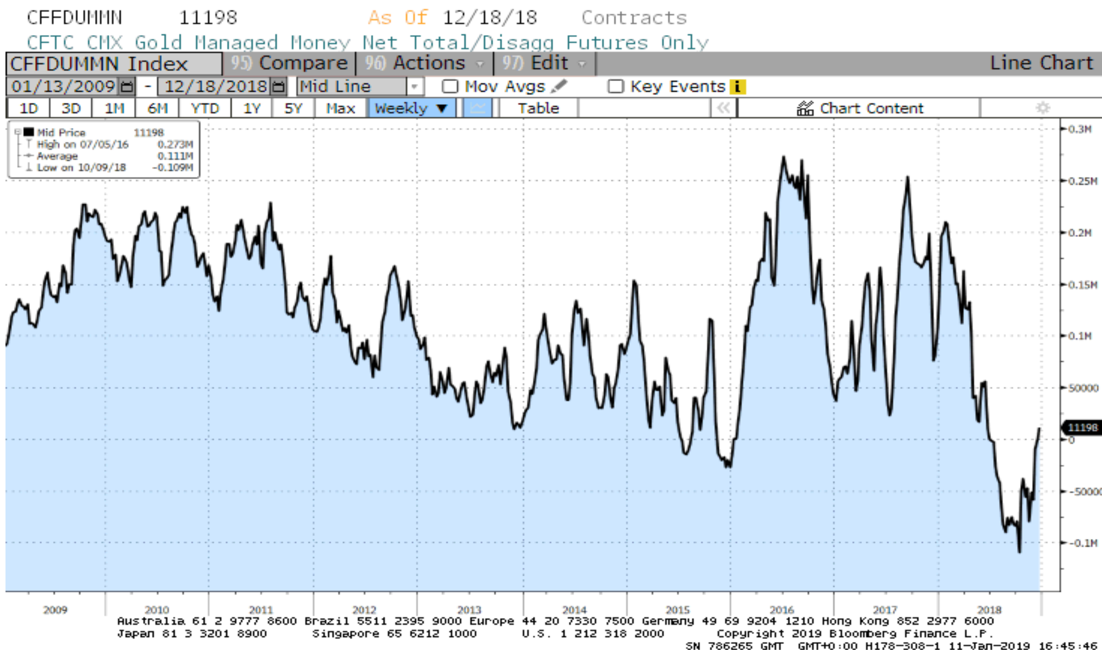
CHINA

In the meantime, some commentators have raised the prospect of China (perhaps in conjunction with the G-7?) introducing their own programme of monetary intervention. This might be along similar lines to the Shanghai Accord of January 2016, when China created new money that influenced and supported global markets.
The People's Bank of China (PBOC) marked a critical shift in the official monetary policy description at the December Central Economic Work Conference, from *"prudent and neutral"* to *"prudent with appropriate looseness and tightness"*.
This seemingly small change in language is similar to that of 2015 when interest eased in China and January 2016 saw the Shanghai Accord, a coordinated response from G-7 leaders and China, which sparked a massive rally in stocks as China unleashed a major monetary easing. It impacted the global economy for the next year and pushed the markets back on an upward trajectory.

Bloomberg also reported that a rescheduling of the Chinese regional legislative meetings has not occurred in more than four decades, yet this rescheduling is taking place between 19th and 22nd January and is an indication that President Xi could be readying major reforms. This could address the trade issue but could also be a local response to any possible failure of trade talks. Watch Chinese developments with interest.

GOLD

In uncertain times we know that precious metals can provide both a safe haven and possible strong returns, an insurance policy if you like. It is also an asset class that has been roundly ignored by most and for some years, but things do change. The following chart shows the net difference between investors betting in favour and those betting against gold and it shows the lowest positive holding of gold since this data can be tracked.



COMEX commitment of trader report (gold net holdings). Source: Bloomberg

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The last time the measure was as unloved as this was in December 2015, when the price of gold then rallied close to 30%. The price of gold in January 2016 was toying with a break down below the US$1,000 level and then made it up to US$1,375 before dropping back. There has been renewed central bank buying reported by the Chinese in particular, so rumours of gold's death have been exaggerated!

Overall, gold has held its own since December 2015 despite monetary tightening so there is underlying supply and demand in the physical market. Russia and China are putting a floor under prices.

It is worth noting that gold mining companies are finding it very hard to make meaningful new discoveries and one of the giants of the sector, Barrick Gold, launched a takeover of Randgold Resources, a £6 billion market capitalised company. The CEO of the combined operation will be Mark Bristow, who ran Randgold and he said at the time of the announced takeover that the industry has:

"too few assets with too many management teams and it needs reorganization."

In other words, there is more takeover activity to come. At the time of writing, Newmont Mining has just announced an offer to buy Goldcorp, another giant of the sector. There will definitely be more to come in this sector.

SUMMARY

Deutsche Bank's fund company DWS and Goldman Sachs expect the S&P 500 Index to reach 3,000 points by the end of 2019. At a current level of around 2,500 points, this would mean a potential of around + 20 percent for the leading US stock exchanges. Whether this actually happens depends on numerous unknowns and risks, such as a possible stronger than expected downturn in the US economy or an escalating trade war between the US and China. The great unknown that is BREXIT will also strike at the end of the first quarter of 2019, when Great Britain will officially leave the EU as at 30 March 2019 – or will it?! We assume, however, that the reasonable forces on both sides of the channel will agree on a mutually acceptable and consensual solution, in order to continue to treat each other reasonably and conduct economic trade in the future, much as Switzerland and Norway, for example, have done successfully with the EU for decades.

The year ahead will be one of opportunity, stock-picking, political shifts and, most importantly, one of central bank activity and intervention. With a debt pile as large as it has become, it is the central bankers who hold the key to the future!

We hope that you have made a good start into 2019 and we look forward to being in touch with you again soon.

Yours sincerely

The SUNARES team

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