Boubyan Multi Asset Holding Fund

Fund Licensed by the Kuwaiti CMA (F/2016/0003)

31 October 2018

بـوبـيـان كـابـيـتـال
Boubyan Capital

Sub-Manager's Commentary:

Market Overview

Global equities suffered significant losses during October, as continued monetary policy normalisation across developed markets began to unnerve investors concerned about economic growth. Emerging markets also saw steep losses as risk aversion spread, with Asia further impacted by worries about continued trade tensions.

Measures of developed-market equity volatility rose sharply in October, as the Chicago Board Options Exchange Volatility Index (Vix) saw its biggest monthly rise since March. Growth stocks led losses, particularly the technology sector. The MSCI Europe Index fell 7.62%, and the MSCI USA Index was down 6.94%, compared to the MSCI World Index, which lost 7.32%, all in US-dollar terms. The US dollar gained against the euro.

All major European equity markets retreated, reflecting ongoing uncertainty around the United Kingdom's exit from the European Union ("Brexit") and unresolved tension between Brussels and Rome over Italy's budget deficit. The European Commission's decision to reject the populist Italian government's draft budget pushed up the country's borrowing costs, meaning the yield on Italy's 10-year government bond rose by 28 basis points (bps) in October, to 3.43%. The European Central Bank (ECB) kept its main rate unchanged in October, pointing to weaker momentum in the eurozone recovery. The ECB is expected to maintain this rate at present levels through the summer of 2019, to keep inflation close to 2% over the medium term. Longer-term inflation expectations remain stable at 1.9%. Ten-year German Bund yields fell 8 bps to 0.39% by month end, as investors sought safety. Japanese government bond yields were unchanged in October—10-year yields remained at 0.13%—following the Bank of Japan's decision to widen the yield-target band earlier this year.

The effects of tighter monetary policy are beginning to show in the US economy. Real gross domestic product (GDP) in the United States increased at an annualised growth rate of 3.5% in the third quarter of 2018 (according to the Bureau of Economic Analysis), lower than the 4.2% annualised growth rate achieved in the second quarter. As a counterpoint to this, September's unemployment rate of 3.7% was a 49-year low, meaning wage rises are likely to lead to further upside inflationary pressures. Inflation remains close to the US Federal Reserve's (Fed's) target of 2% currently, suggesting monetary policy is working, but further rate rises will depend on inflation expectations and economic growth projections. Ten-year US Treasury yields remained above 3%, ending the month 8 bps higher at 3.14%. High-yield corporate bonds lost ground during October, along with the equity slump, underperforming investment-grade corporate bonds and US Treasuries.

Emerging-market (EM) stocks fell heavily in local-currency terms, which translated into a loss of 8.70% in US dollars. Ongoing trade tensions, coupled with a rise in risk aversion, made October a challenging month for Asian emerging markets. China-based equities lost 11.47% in US dollars over the month, despite government intervention in the market during October, designed to support stocks. European emerging markets were more resilient, losing 5.49% in US-dollar terms, helped by the appreciation of the Turkish lira against the US dollar. Latin America was the only EM region to register gains in October, due to the strength of Brazilian stocks, which rose 17.83% in October, in US-dollar terms, boosted by a stronger real. The election of far-right politician Jair Bolsonaro as president drove confidence in the Brazilian economy. EM local-currency bonds fell, as did hard-currency EM sovereign bonds, in US-dollar terms, further reflecting global market uncertainty.

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Broad commodity prices fell sharply in October, driven by oil prices, which experienced their biggest monthly decline since 2016. An uncertain outlook for global growth and rising US inventories dragged down prices. The price of Brent crude oil fell to US$75 per barrel by month end, while gold rose to US$1,215 per troy ounce.

Outlook

We do not believe that the current market sell-off is large enough to influence the longer-term economic outlook. At this stage, it may have some lasting impact on the level of risk that investors are willing to sustain, while causing some repositioning of portfolios. The more interesting assessment over the coming months will be to see whether the mood of other investors shifts from buying on the dips, to a preference to reduce growth exposure on any recovery. Investor psychology may be informative.

The highlights of our analysis include the following:

• We have a slightly less positive outlook on global growth than was the case in 2017 or the early part of 2018. While global trade is slowing, the US business cycle remains supportive of a continued period of sustained growth.
• Corporate fundamentals are currently on par with historical norms, with above-average margins and healthy earnings revisions. Profitability may be close to a peak, but we view capital expenditure as likely to support productivity and sustain growth in earnings.
• The United States remains an oasis of relative calm and increasingly elusive economic growth. This underlying story had not been changed much by more recent market moves or by softening growth momentum in many economies.
• China's proactive steps to support its economy—lowering bank reserve ratios and promising tax cuts—appears to be affirmation that global growth divergence is real and worthy of attention.
• Increased market volatility during October makes us cautious about increasing risk exposure more broadly until we see a stabilisation in some of the growth momentum indicators that we follow.
• Ongoing global growth and risks of inflation heading higher lead us to prefer lower exposure to government bonds and duration. Long-term valuations have remained expensive despite the rise in yields, reflecting low term premiums.
• While valuations have been tight, the economic backdrop remains supportive of riskier fixed income sectors such as high yield. We believe bank loans can be an attractive complement to high yield, given less sensitivity to Fed rate hikes.
• Selective positioning in EM remains important, as some countries are better prepared to withstand sector headwinds and are less susceptible to fears of contagion. Central banks in certain EM countries (including India, Indonesia and Brazil) have employed tighter monetary policy, in order to combat higher US rates and protectionist trade policies from the United States.

We maintain a modestly lower conviction in EM stocks and a neutral view of equities and growth assets more generally. Within fixed income, we prefer shorter duration in sovereign bonds, although long duration on safe-havens like US Treasuries is tactically appealing. We are more positive on higher-yielding corporate bonds.

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