Omba Advisory & Investments Limited

1H > 2H

July 2018

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OMBA
ADVISORY & INVESTMENTS

1H > 2H

Contents

As we move through the second half (2H) of 2018 we worry the first half (1H) might have delivered better returns than the second half will.

You may recall that at the start of the year we provided a very short summary of what people were thinking titled "**18 Outlooks for 2018**". In that report we highlighted in one paragraph the consensus view on how major markets would perform and where the prognosticators thought one should over or underweight their investments. The below table shows how they have fared.

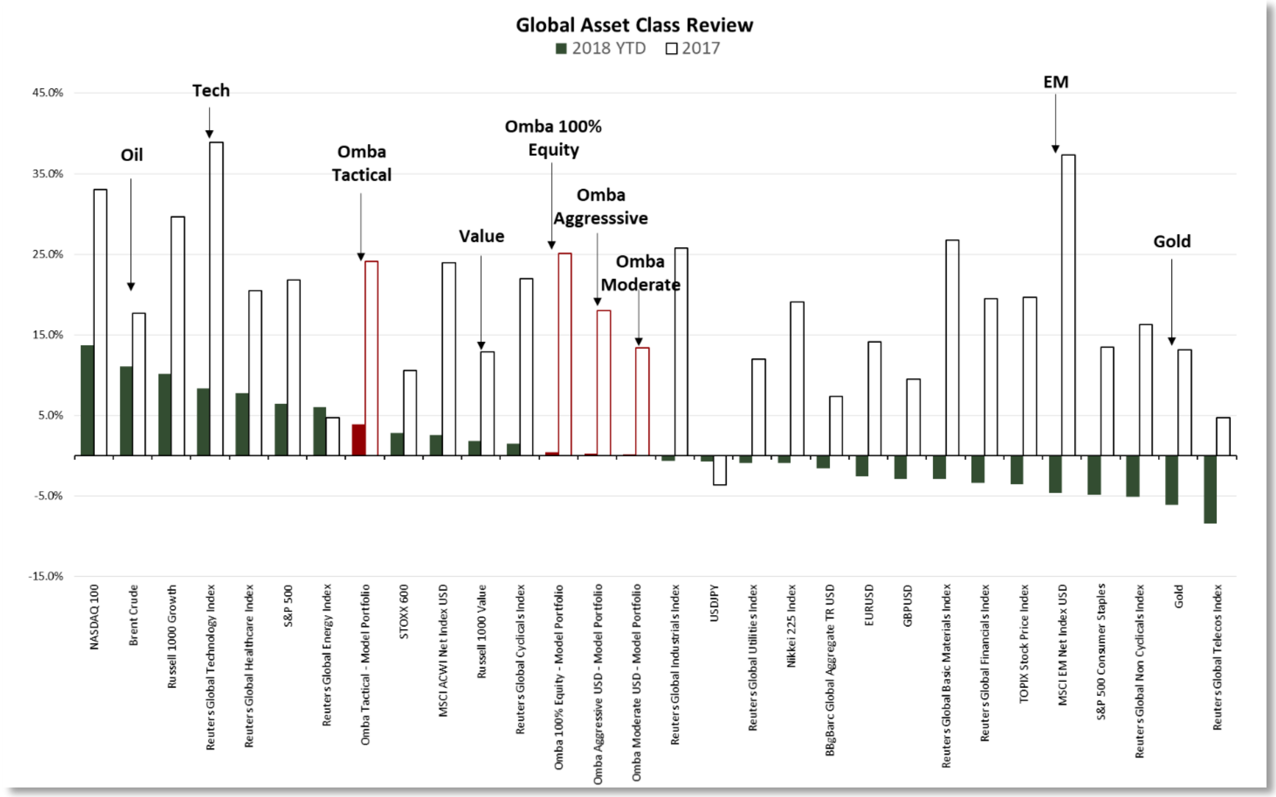
Expectations formed at the beginning of 2018	Right or Wrong?	Indicator change H1 2018
US Fed Funds Rates continues to rise	✓	2 x 25bps hikes in H1
BoJ to keep policy rates unchanged	✓	No change
ECB to keep policy rates unchanged	✓	No change
UK will continue their hiking as inflation continues to trend above target	–	CPI remains above 2% target. No rate hike in H1. 25bp rise in August '18.
The years of easy money are coming to an end which could (not this year according to almost everyone) lead to asset price corrections	X	February's price correction was mostly not expected.
Remain invested in equities	–	Mixed results
Underweight US Equities [1]	X	1.72%
Overweight Japanese Equities [2]	X	-3.84%
Overweight European Equities [3]	X	-0.35%
Overweight EM Equities [4]	X	-6.66%
Overweight EM local debt [5]	X	-6.88%
Overweight USD-denominated debt [6]	X	-6.12%
China continuing to grow around 6.5%	✓	Q1 GDP YY at 6.8% Q2 GDP YY at 6.7%
USD will continue to weaken against major developed currencies [7]	X	USD stronger, up 2.86%

[1] As represented by the S&P 500 Total Return Index in USD.
[2] As represented by the Topix Net Return Index in JPY.
[3] As represented by the Europe Stoxx 600 Net Return Index in EUR.
[4] As represented by the MSCI EM Net Return Index in USD.
[5] As represented by the iShares JP Morgan EM Local Gov Bonds ETF.
[6] As represented by the iShares JP Morgan $ EM Bonds ETF.
[7] The USD strengthened by 2.83% against a basket of developed market currencies in H1 2018.
www.federalreserve.gov/releases/h10/Summary/indexn96_b.htm

This is a reminder of the comment we posted in Jan 2018 about the consensus view, "If you're short on time and want to read one paragraph which summarises the gist of the 'aggregate' view, it's this one. Most pundits, seers and smart economists are bullish for 2018. Interest rates in the USA will rise as the Fed continues their path of hiking rates. The Bank of Japan and European Central Bank will keep policy rates unchanged during 2018 while the UK will continue their hiking as inflation continues to trend above target. The years of easy money are coming to an end in the USA and sooner or later (2019 and beyond) in Europe. This could (not this year according to almost everyone!) ultimately lead to asset price corrections. They generally recommend staying invested in equities with an underweight to the USA and overweight to Japan, Europe and Emerging Markets. Many believe Emerging Markets (equity and EM local and USD-denominated debt) are the place to be for 2018 both due to robust global growth, China continuing to grow around 6.5% and a commodities cycle (which benefits EM in general) remaining robust. The general thinking is that the USD will continue to weaken against major developed currencies, something already borne out in January thus far. The generic risks highlighted by almost everyone include: Geopolitical risk (North Korea tensions, Middle East etc); hard Brexit; EU instability due to Spain (Catalonia) tension or upcoming Italian elections; Trade war between USA and China; NAFTA negotiations; Global cyber-attacks affecting IT services; Terrorism".

2017 and 2018 Asset Class Performance – Half full or half empty?

What becomes clear from the chart below and the data above is that 2018 has definitely been a more challenging environment for generating positive returns and as usual nobody can accurately predict the future. Depending on the asset class, region, country or sector an investor could have experienced significantly different returns with the Nasdaq100 delivering positive **13.7%** and Gold delivering a poor **-6.1%** alongside Global Telcos **-8.4%.** The solid green and red bars below are the 2018 asset class performance numbers and you can see the bifurcation of returns.



YTD performance is to 31 July 2018. Returns are in original currency unless otherwise indicated. Data sourced from Thomson Reuters, 2018. Omba performance data sourced from Morningstar is and is gross of fees. Omba performance has been simulated based on an actual portfolio designed in December 2016 and actually invested on 10 April 2017.

Our most important snippets of news from 1H and some thoughts thereon…

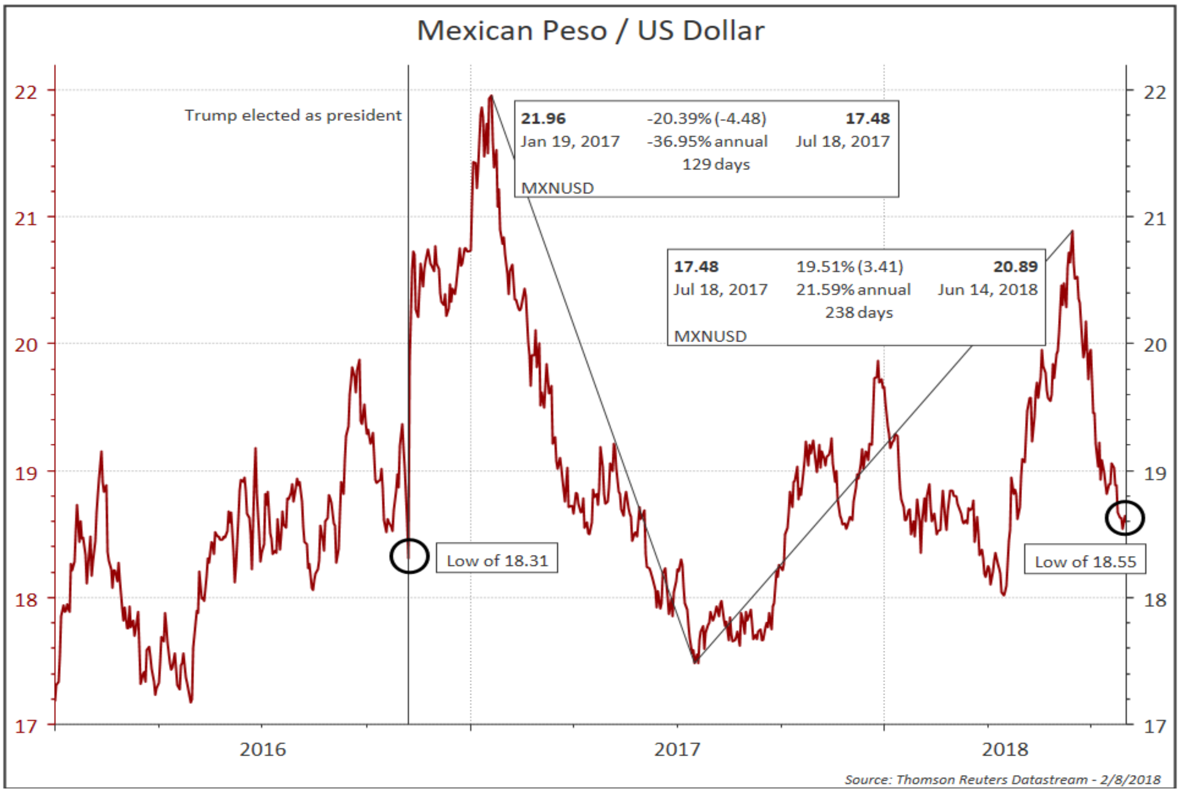
Given you are probably bombarded with news from Social Media, Apps you have on your devices, Emails, Television, your Asset and Wealth manager/s and your bank/s we thought we would highlight the 10 most important snippets of news from 1H which we think have or will impact global financial markets.

1. **Trade relations**

   Most notable is the US and China trade war unfolding but it has not been limited to the USA and China (Canada, Europe, Japan and Mexico have also been targeted). The Trump administration seems adamant that tariffs on imported goods will be good for the USA as they will create more jobs in the USA and reduce the US deficit. We disagree. The impact will be bad for the USA as increased tariffs will cause imported inflation as the price of goods will be higher (all else equal incl. currency for now), this inflation will hit the US consumer the hardest. Increased inflation will require the Federal reserve to hike interest rates to curb inflation (for the basics of why see here: OMBA FAQs). Increased interest rates will further hurt the US consumer (think of motor vehicle, credit card and mortgage finance and the impact of higher rates on debt servicing costs). The corporate sector will also have to fund at a higher rate and thus companies will pay more interest and produce lower earnings. So, at the end of the day we think trade tariffs will have a negative impact on the USA. The rest of the world will also suffer as sales to the USA (by the rest of the world) would take an initial knock. One factor which would perhaps counter the impact of this for the USA is that the US Dollar could continue to strengthen vs other currencies (like the Chinese Renminbi) and thus when goods are purchased by Americans from abroad (China) the impact of the tariffs would be felt less as the amount paid in USD would be similar if the currency devaluation of the selling country (China) was equally offsetting. This discussion takes us into the world of currency wars! Another topic for another time.

   What is most ironic is that one of the main reasons for the tariffs is to reduce the US trade deficit but the Trump administration at the same time has announced a fiscal stimulus and tax reforms (lower taxes) which will both significantly increase the US deficit…go figure.

   Overall you will see that the trade wars are complex to understand and given the uncertainty of the outcomes it is likely there is increased market volatility in months and years to come. Additionally, correctly predicting the direction of a country's stock market or currency based on trade related discussions is very difficult - Mexico being a good case in point. See the chart below showing how the Mexican Peso has fared vs the USD over the course of the Trump administration. It ends up (almost) where it starts but with some wild swings in between mainly driven by sentiment and rhetoric relating to NAFTA talks.

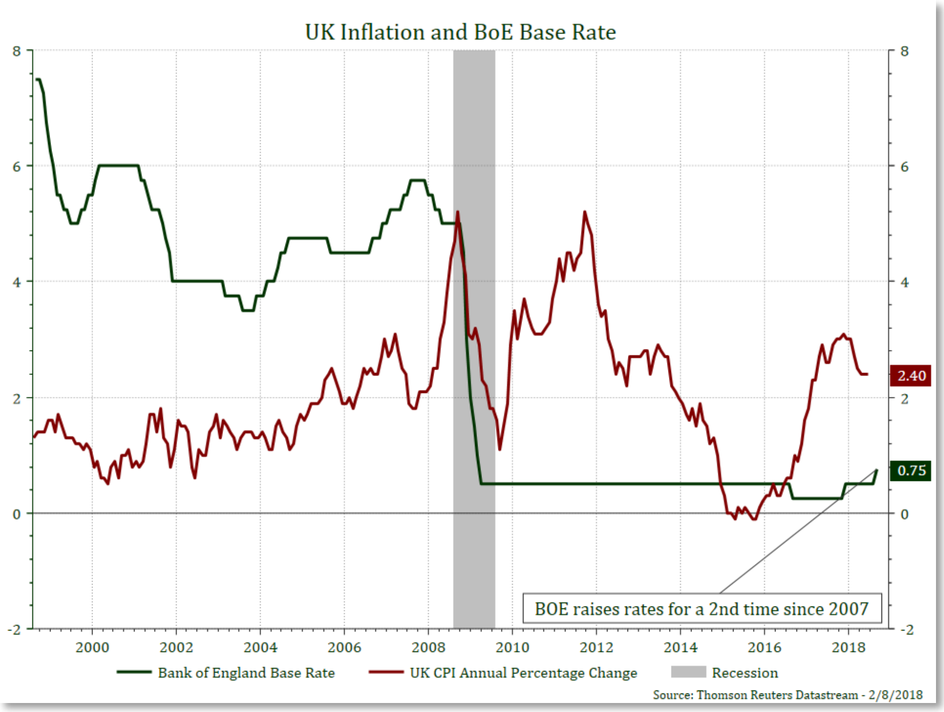


2. Brexit

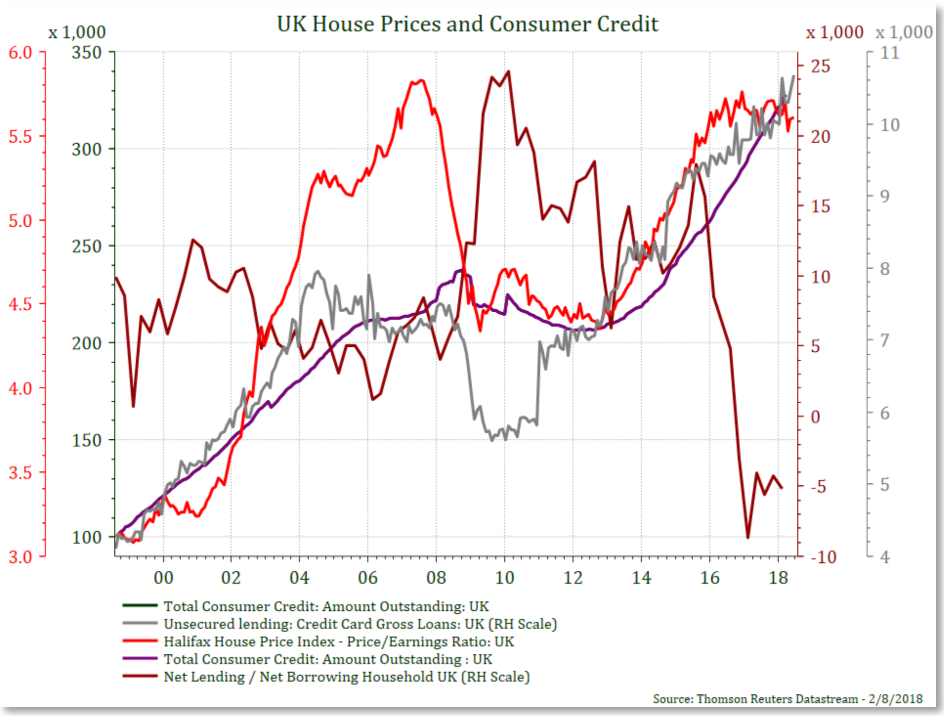
Although less impactful on a global basis, the Brexit challenges, as the UK negotiate their departure from the European Union, are becoming more acute. We began the year with the general tone being a likelihood of a soft Brexit, but the tide has turned and the likelihood of a harder Brexit (or no deal) is increasing. There is even the possibility, although more remote, of Brexit being halted due to strong campaigning from factions. The biggest challenge in it's rawest form is: how do the UK and EU27 agree open borders for trade without the free movement of people across those borders. The four freedoms of the EU allow for the movement across borders of goods, people, services and capital.

At the moment the UK economy seems to be quite resilient with the recent MPC meeting of the Bank of England (BoE) indicating that unemployment is at a 42-year low, wage growth is edging higher and due to the meaningful fall (>15%) in Sterling, exports have been supported. The concerns however are that the BoE have recently begun a rate hiking cycle not only to cool the economy but also to curb inflation which has risen due to the fall in Sterling since Brexit (i.e. the UK is importing inflation). This makes the likelihood of a UK slowdown greater. A no deal or hard landing scenario would only exacerbate this.

Given the extent of the increase in borrowing and the high level of property prices in the UK, particularly London, we worry that the storm of higher inflation, higher interest rates, higher levels of household debt coupled with a slowdown in the economy due to Brexit could all cause a deeper or longer recession depending on the fiscal or monetary policy responses.



As can be seen in the above chart inflation is running above the 2% target and rates need to catch up thus the likelihood of further hikes remains high.



"In 2017, the savings ratio — measuring the proportion of income that is not spent — dropped to 4.1 per cent, its lowest rate for more than 50 years."[8] As can be seen by the maroon line in the

[8] The UK economy since the Brexit vote — in 5 charts, FT.com, 31 July 2018.

above chart, households have moved into a net borrowing position– borrowing more than they save on a quarterly basis – for the first time since 1989. What bodes from this is a more vulnerable consumer in an uncertain time for the UK when interest rates are on the up – we watch the UK economy and market with caution.

3. Iran nuclear deal

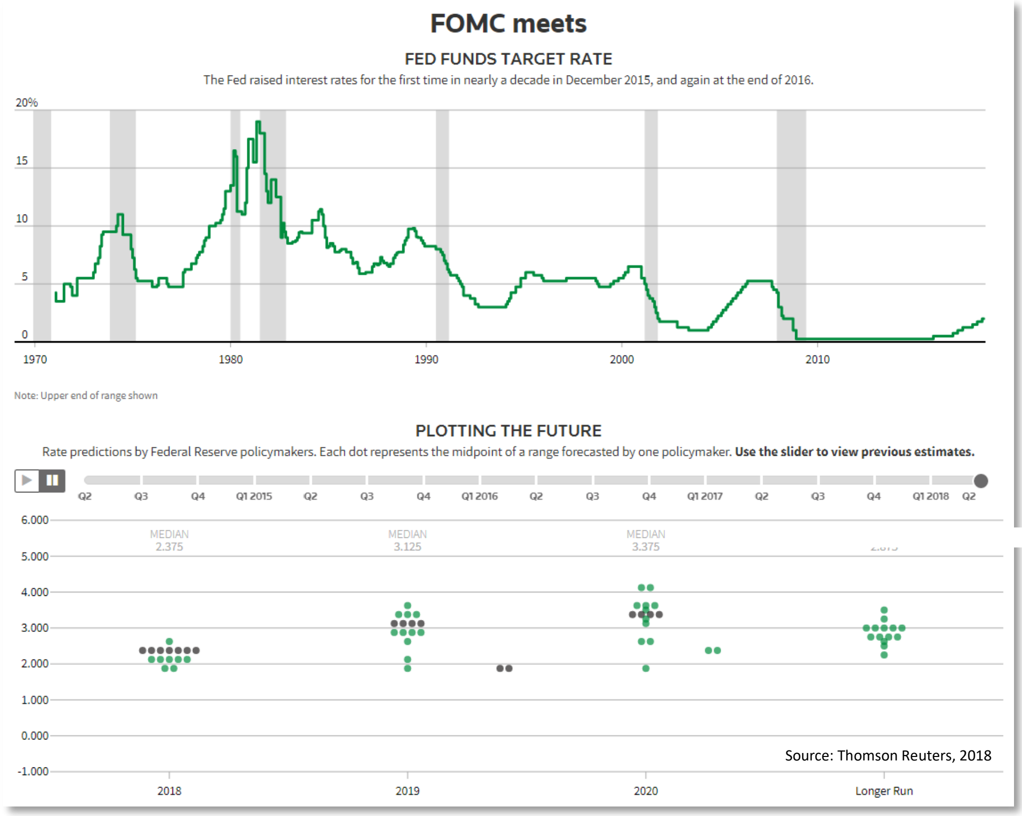
In May Trump chose to withdraw from the Iranian nuclear deal known formerly as the Joint Comprehensive Plan of Action established during the Obama administration. The USA has already begun sanctions on Iran and there are plans to begin curbs on Iran's oil exports in November. One of our concerns is that Oil prices spike which has negative impacts on financial markets. There are also other issues which need addressing like the fact that many European countries and companies have begun doing business with Iran since the original deal was signed and this trade is not currently being unwound thus impacting US-EU relations which have recently also become tenser.

4. North Korea

Tensions between "Rocket Man" and the "Dotard" have drastically improved to levels not quite expected by financials markets earlier this year. The landmark June summit hosted in Singapore, where the two leaders met to discuss a number of key matters including denuclearisation of North Korea, is the reason for this improved dialogue. While there is a long way to go before the tensions in the Korean peninsula ease completely, the concerns which prevailed at the beginning of the year have waned.

5. US Federal Reserve and a flattening yield curve

Jerome Powell replaced Janet Yellen as Chair of the Federal Reserve in February 2018. The Fed continued to raise rates in March and June with two further hikes expected in H2.



The US yield curve continues to flatten with the 10-year 2-year spread at 29 bps at the end of July 2018. The global yield curve has already inverted. While an inverted yield curve has historically preceded recessions, a number of market commentators argue that “this time may be different”.

“The term premium is estimated to be at historical lows, dragged lower by global central banks’ large holdings of government bonds, and the low level of both inflation and the volatility of inflation. This has kept long term interest rates lower than the values that would be suggested by economic fundamentals, keeping the yield curve flatter than otherwise. The fact that the yield curve has flattened while inflation expectations have remained stable, and even firmed according to some indicators such as breakeven inflation, is another signal”.[9]

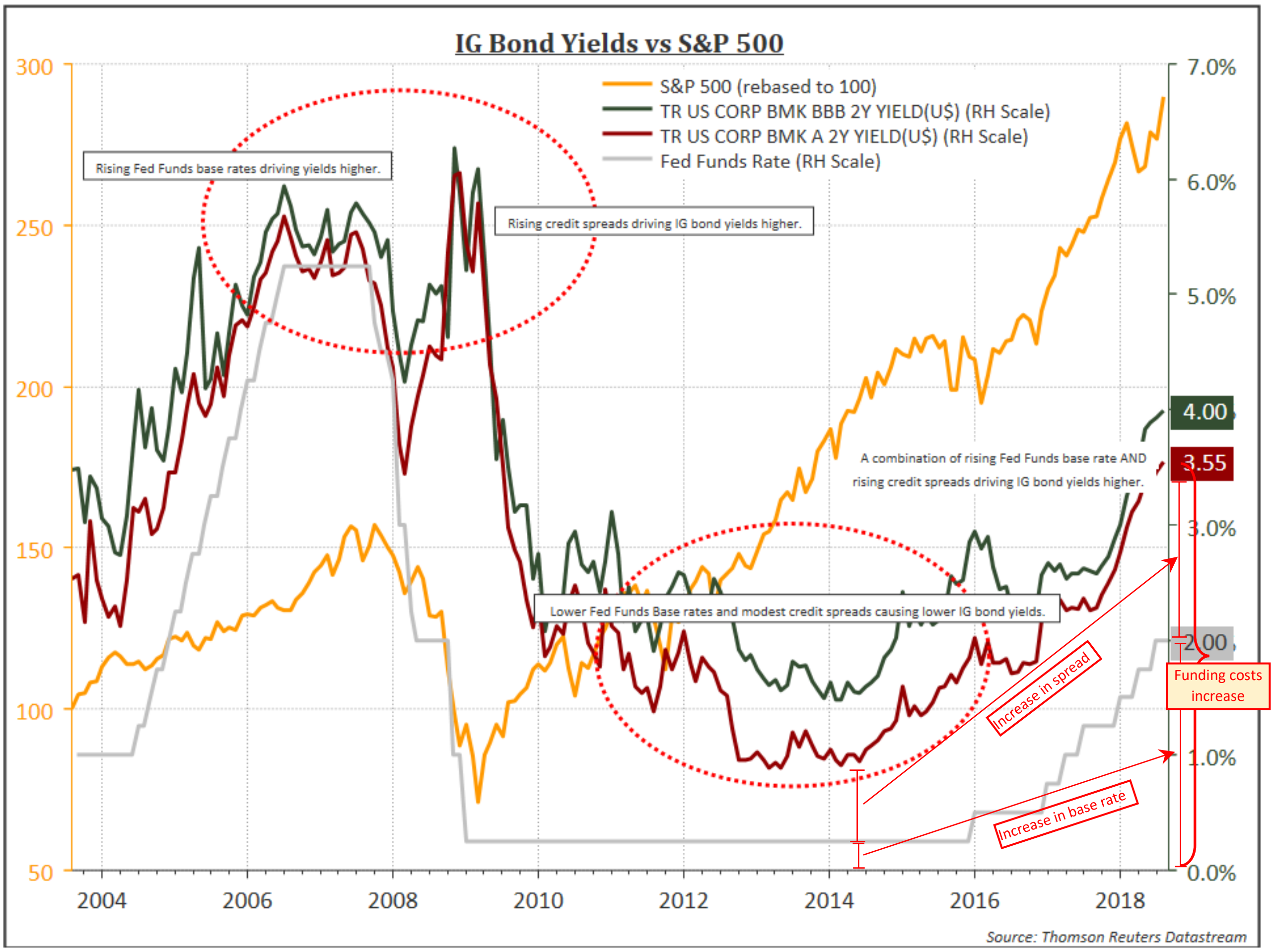
We believe the single biggest factor in what happens in financial markets is linked to the Fed hiking interest rates. The US consumer and the corporate sector have both re-levered their balance sheets and borrowed more due to the historically low interest rate environment. Many consumers will have mortgages, credit cards and motor vehicle finance linked to the base rate and a rise in the rate will cause increased interest costs and repayment requirements if not now (due to there being a fixed rate period) later down the line. One must not forget the impact of ARMs (Adjustable Rate Mortgages) during the US sub-prime crisis. As the easy initial borrowing terms reset the defaults and foreclosures rose dramatically. Many credit issuances get structured in a similar way and there is often a cliff at which point the easy terms fall away.

Additionally, the Investment Grade Corporate Credit issuance has doubled since 2007 with a larger % of issuers in the BBB category than preceding the global financial crisis. Since the

9 Is the flattening of the yield curve a signal of economic weakness ahead?, GS ISG, April 2018.

beginning of the year both High Yield and Investment Grade Corporate Credit spreads have risen due to the Fed Funds rate having risen and an increased pricing in of default risk. This means the cost of new issuance (i.e. funding rates) for companies has risen, which is a tightening of financial conditions for corporates. As an example, 10-year A-rated corporate bond yields have increased from 3.65% to 4.37% in 2018 with spreads over 10 Year Treasury Bonds increasing from 55bps to 72bps.

As Citigroup notes, “the technical shifts we are witnessing today in IG credit could very well be the early indications of a rotation by international investors away from US credit markets – one that would presage tighter financial conditions, and wider spreads, for years to come…”[10]. The reason for this is that as short-term USD rates rise, the cost of hedging for foreign investors in lower rate countries rises (e.g. Germany and Japan).



6. Higher Oil Prices

Oil prices have risen strongly from $48 in mid-2017 to $74 at the end of July 2018. Oil is notably one of the best performing asset classes for 2018, but this comes at a cost for other sectors. The downside to higher oil prices is higher input costs. These higher costs are passed on to the consumer through cost-push inflation or can be absorbed by businesses through earning lower

10 Citi, US High Grade Strategy Focus “The bps come out at night”, 11 July 2018.

margins. This can lead to slower economic growth. As mentioned earlier, geopolitics and the impact on oil prices remains a continued risk.

7. China

Chinese growth is expected to moderate in 2018 and inflation should remain largely benign. The government's deleveraging efforts has made progress in the financial sector, but it has started to have an impact on the real economy. Trade tensions with the US will likely create headwinds for growth going forward, but the government is taking measures to offset the downside risk. The main point to note in this regard is that although the US have imposed tariffs on Chinese imports into the USA the Chinese Renminbi has devalued against the USD by nearly 9% from its strongest level during 2018. This has helped keep Chinese goods competitively priced and thus we don't think will have as dramatic an effect on trade as Trump would hope.

We do remain concerned however that China's Debt/ GDP ratio is around 280% and the rebalancing of its economy from being mainly investment led is progressing slowly. Although the Chinese CSI 300 index has taken a knock YTD a large portion of this pull back is more because of the government's effort to reign in credit growth and curb activities in the shadow banking sector than because of US-China trade relations.

Omba's current (31/7/2018) equity tactical positioning

Below is a summary of our tactical positioning within our equity allocations across all portfolios we manage. These are typically 6 month to 24 month over-weights or under-weights we make to our allocations and are driven by a combination of valuation screening, price dislocation or geopolitical or economic factors which may cause us to change our allocations.

	Under-weight	Over-weight	Tilt YTD (31/7/18) or tilt holding period (if different)
EMEA			
Stoxx Europe 600	– 13%		
Healthcare (*added position in April '18)*		+ 6%	11.18%
European Stoxx 600 Value		+ 5%	1.33%
Spain		+ 3%	0.88%
Stoxx 600 Oil & Gas		-	11.49%
(removed 2% over-weight in May '18)			
AMERICAS			
S&P 500	– 8%		
Consumer Staples (*added position in June '18)*		+ 5%	5.04%
US Financials		-	-1.16%
(removed 3% over-weight in June '18)			
ASIA PACIFIC			
EM Asia *(-2.13% YTD)*	– 3%		-
CASH *(increase in H1 from EM Asia)*		+3%	2.13%
CASH		+2%	-
Combined long-only tactical performance[11]			3.99%

European Healthcare – we shifted into this globally diversified and defensive sector as it was at multi-year lows and also trading at a discount to the US Healthcare sector. The sector is also supported by long term demographic trends and technological advancements. This, along with the essential nature of healthcare spend, should help insulate the sector from adverse rises in interest rates. The sector is traditionally more defensive and given we are later cycle we prefer more defensive sectors which hold up better in markets which correct.

European Value – we remain overweight value-oriented stocks via a Value Factor Smart Beta ETF. The stocks therein are trading at lower multiples. Again, we favour their defensive nature in the current market conditions where we are seeing an increased likelihood of heightened volatility and potentially a change in market conditions that won't favour growth or momentum stocks but rather more value-oriented ones.

[11] Return is calculated on the Omba 100% Equity model portfolio using Morningstar. Tactical performance includes the performance of cash (the return for cash has been fixed at zero).

Spain – we remain overweight Spain as the Spanish economy continues to grow at about 3% per year (since 2015) with unemployment continuing to fall. The political instability (first the Catalonia referendum and more recently the ousting of Mariano Rajoy through a no-confidence vote) has dented the stock market performance but in doing so has presented an opportunity for potential outsized returns relative to broad Europe as the political uncertainty dies down. The effectiveness of Pedro Sánchez's minority socialist government remains to be seen but we believe we entered the overweight at a sufficiently low enough level to give us a safety buffer.

European Oil & Gas – we removed our overweight position after a strong rally in oil prices (a high since 2014) and at a time when news of US sanctions against Iran peaked and supply-side concerns were generally heightened. We held this position throughout 2017 when it underperformed the Stoxx 600 as energy prices remained low, but our had conviction in our thesis that the likelihood of higher oil prices at some point, due to geopolitics or supply side issues, would pan out. This happened at the start of the year.

US Consumer Staples – we increased exposure into this sector due to its defensive nature and relative attractive value proposition, with recent underperformance (and multiple contraction) compared with European and Asian consumer staples. Top holdings are large globally diverse companies. The sector is also trading at an attractive dividend yield of 3.3% compared to the S&P500 Index at 2.3%. Historically the sector performs well on a relative basis in times of stock market volatility.

US Financials – we closed our overweight position to US Financials as the sector came under pressure in late May as strongly rising rates and the flattening of the yield curve added pressure to the sector, which may underperform in the future as lending slows, bad debts rise, and the short and long-term rate differentials decline (curve flattens). There is the argument that higher interest rates, potentially lighter regulation thanks to the Trump administration and a strong US economy support financials, but we don't feel the upside outweighs the risks.

Omba's 2017 Tactical Tilt Performance Chart

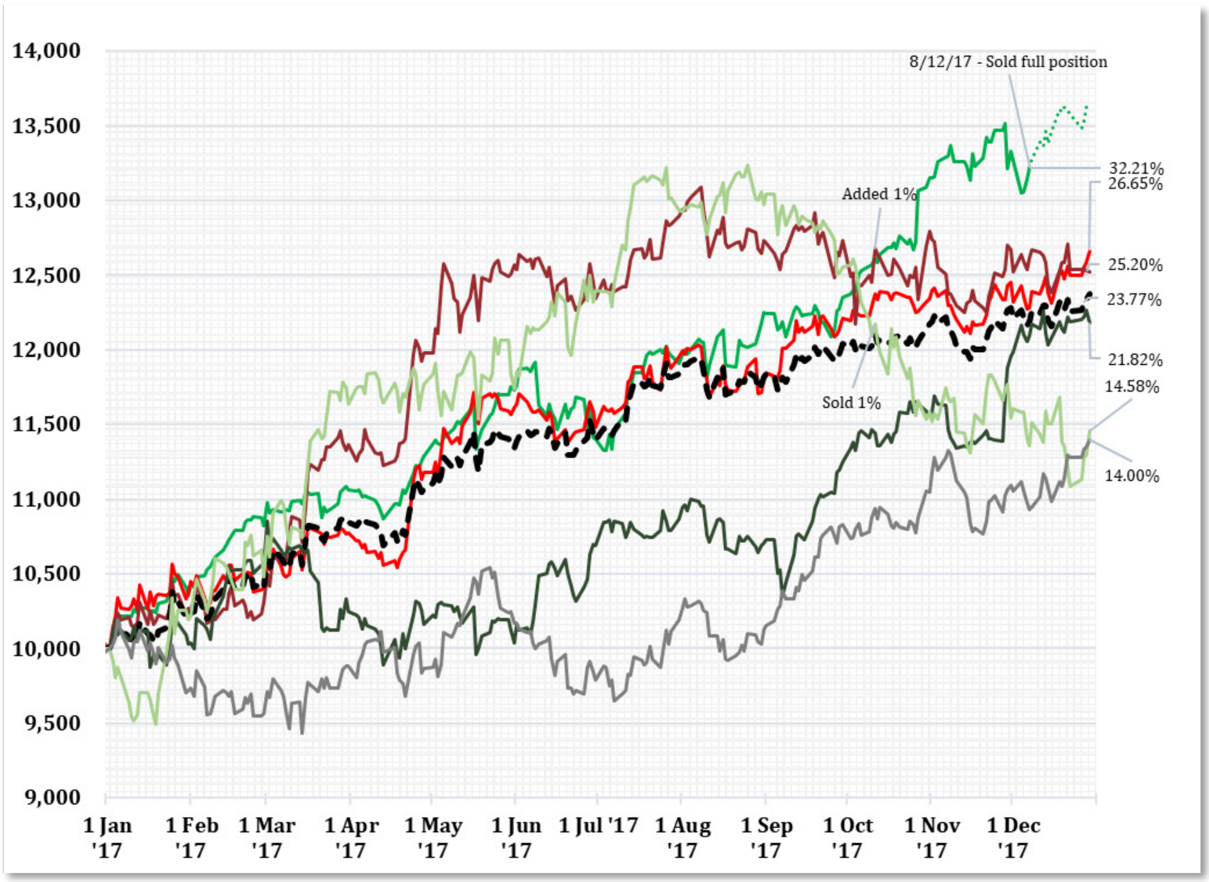
Tilt changes within equities during 2017:

11 Oct 2017 – Sold 1% from Mexico overweight

11 Oct 2017 – Added 1% to Spain overweight

08 Dec 2017 – Sold full position of 3% overweight to US Technology Sector

1 January 2017 – 31 December 2017



Omba's Performance is gross of fees (0.3% p.a +VAT where applicable) and includes dividend income earned.

Past Performance is not a guide to future returns and the value of your investments may fall as well as rise. The above performance is based on a portfolio designed in Dec 2016, implemented from 1 Jan 2017 and invested into on 10 April 2017. Data is provided for illustrative purposes.

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