"They are at again – engaging in willing risk-taking, finding risky deals and creating risky market conditions – it's time for yet another cautionary memo. Too soon? I hope so; we'd rather make money for our clients in the next year or two than see the bust that gives rise to bargains." Howard Marks of Oaktree Capital

Review

Last week continued the trends seen most of July – a weaker USD, softer developed market (DM) sovereign yields and rising equity markets. As ever markets took any news that could be 'dovish' for USD and ignored other data. From my stance, Federal Open Market Committee (FOMC) minutes were unchanged and reiterated the plan to start unwinding Fed's $4.5trn balance sheet sooner than later (consensus expects this to start September), yet markets took it as 'dovish'. On the other hand, markets ignored weaker EU Purchasing Managers' Index (PMI) data, suggesting GDP growth might be peaked-out in Q2 and rising political tension between 'core' EU, with Poland & Eastern Europe, not to mention Italy's migration crisis frustration, to push Euro above 1.17. SPX, in part helped by the weaker USD and robust Q2 earnings and revenue 'beats', tested all-time highs again along with N'DAQ and Dow. SPX IT sub-index also finally rose above its CY2000 previous high. STOXX, on the other hand, peaked in May and having clearly suffered from the stronger EURO, up 5% in last month that hit exporters – notably the Car Manufacturers. Despite JPY/USD volatility, and concerns over Japan PM Abe's longevity after his popularity rating plunged below 30% (a past death zone for LDP leaders), Nikkei 225 held onto 20,000 'handle' helped by optimism on earnings. Elsewhere HK and H shares had a strong month, up 6% and 4.5% respectively, as mainland retail investors rotated out of the speculative ChiNext index into 'blue chips' listed in HK. Samsung's Q2 results, which beat forecasts, helped power along KOSPI (20% weighting) as well as saw it overtake INTEL as the largest semiconductor company by sales, and also APPLE, to become the most profitable non-financial company globally!

The waxing and waning of USD was reflected in DM sovereign yields that moved up from year to date (YTD) lows at 2.12% a few weeks back, to test technical resistance at 3.37% before pulling back last week below 2.3% as more 'dovish' sentiment set in and Fed Futures for another rate hike by YE17 fell below 50%. Whilst markets found every way possible to interpret Yellen and FOMC comments as dovish, Draghi and other ECB officials' accommodative language was disbelieved. Bund yield was more resilient but also failed at technical resistance around 60bps to fall back to 54bps. US Investment Grade (IG) Fixed Income (FI) spread over US Treasury (USTs) fell to within 2bps of the all-time low, with BBB and BB at record low spreads whilst emerging market (EM) FI yield is now below USD high yield (HY) yield for only the 3rd time in history. Gold has proven resilient lately, even on more hawkish data, holding support at $1,220-30/Oz earlier in the month before rebounding above $1,260/Oz this week despite close to record short contracts equal to 19mn/Oz. Oil appears to have found a floor around Brent price of $45/brl, with Brent rebounding above $50/brl after OPEC and some key non-OPEC producers appear to have agreed to further production and export cuts and a large drawdown of US crude oil inventories.

Outlook

This monthly outlook section will draw heavily on the cautious view expressed in the latest investment memo written by the Howard Marks, the head of Oaktree Capital, and much admired by this author. Before heading more into the key points made by Howard (ones we agree with but put rather more elegantly by him), I would note he explicitly admits he is often too early in his warnings and may well be so now. Howard's main point is that we are in a high risk yet low return investment world yet there are increasing signs investors are behaving as if we were in an opposite world with increasingly risk 'bets' that are not obviously justified by the returns. His rather obvious conclusion is that this merits caution and a more defensive investment approach with care taken in making the right relative investment choice.

Howard goes through the various main asset classes to illustrate where he sees excessive valuations, noting that SPX looks the most expensive, other than before the crashes in '29 and from the '00 TMT bubble (at 29x CAPE P/E Ratio AND 25x trailing P/E ratio, the historical average being 16x). He notes the current concentration in FAANGs reminds him of past such 'invincible' themes as 'nifty-fifty', energy stocks in the '70s and TMTs in '90s came to grief and history of TMT boom to bust has some potential similarities to current FAANGs optimism. He is sceptical on the record low volatility index (VIX) level is a useful guide to riskiness as it reflects what option takers are thinking now but not what will happen in the future. He also questions the common sense of over $1trn moving into passive ETFs he describes as 'value-agnostic' investing.

He rightly notes that sentiment towards EM swings violently from over-optimism and DM-type valuations to extreme pessimism but, with EM fixed income yields below USD HY yields for only the third time ever, it might be that we are close to the high end of EM valuations now. He notes the huge inflows into higher-risk credit assets AS PART OF THE 'HUNT FOR YIELD', despite the massive reduction in covenant protection, and that investors are now buying bonds they would never have before at record low yields, suggesting at least the possibility of irrationality. Howard highlights the YTD record surge of inflows to private equity (PE) YTD, equivalent to a leveraged buying power of $1trn plus, on top of already huge equity capital of $800bn in such funds, from earlier years of fund raising, that is pushing up PE valuations. In particular he questions the merits of SOFTBANK's $100bn PE fund, the largest in history, which has already raised $93bn despite what appears to be questionable corporate governance. Another sign, in his view of risky behaviour, are the amounts going into crypto-currencies that have no value and are more a gamble than an investment as it has more in common with Ponzi schemes as the Tulip craze or South Sea bubble and reminiscent more recently, again, of the mania for loss-making TMT stocks.

Howard simply thinks investors are buying 'high', when expected returns are likely to be low across almost all asset classes, indiscriminately of risks involved. "For all the things listed above to simultaneously be gaining in popularity and attracting so much capital, credulousness has to be high and risk aversion has to be low…they show the temperature of today's market to be elevated. Not a nonsensical bubble – just high and therefore risky." I am sympathetic to much of the common sense warnings Howard makes and we are prudent in how we are constructing our portfolios with careful selection of asset classes we think, in a relative and absolute basis, reflect some of the dangers. We currently have a very low exposure to FI, a relatively low exposure to expensive equities and a higher exposure, to traditional portfolios, in low volatility funds. On top we run a disciplined risk management system monitored in real time, which we believe enables us to quickly raise cash or shift to be more defensive. We remain invested as we, like many others, do not see the immediate risks but, as Howard notes, when almost everyone can't think of the short term adverse catalyst anytime soon, "is precisely when people can't see what it is that could make things turn down that risk is highest as they tend not to price in risks they can't see".

US Equities - Review

- US equities continue to roll-on, ignoring the political impasse, mixed macro-data and worries about valuations. Q2 results, for 50% or so that have reported, are seeing 'beats' by 73% in both revenues and sales – the important difference being this is the first time revenues are materially beating since 2010/11 post-GFC rebound. A weaker USD is helping with revenue 'beats' by international companies with almost 2x than those more domestically focused. Rotation away from IT to Financials continued last month.
- Macro data was mixed, with still tepid retail sales and inflation seized upon by myopically 'dovish' FI markets. On the other hand, latest Consumer Board consumer index, Markit PMIs, June non-farm payroll (NFP) and other data were strong or even very strong. US Q2 GDP 'missed' slightly but was up strongly from 1.2% Q1 at 2.6%
- The main story was the bizarre goings-on around Trump and GOP. The failure to get even a 'skinny' repeal of the Affordable Healthcare Act helped sustain the political gridlock thesis. With John Kelly replacing Priebus as Chief of Staff, Trump is surrounded by generals!

US Equities- Outlook

- Our fair value target for SPX is 2,500 based on 11% earnings per share (EPS) growth in FY17E, and 19x PER. The key to further SPX gains depends on earnings meeting expectations that might be a tall order Q3 onwards as a favourable base in H1 switches to being tougher in Q3 onwards. Earnings for FY17 have seen three months of net, albeit modest, downgrades, mainly from Energy on lower oil prices, to now rise 9% FY17 and 11% in Q2. The key sector at risk to weaker earnings surprises is obviously in the IT space and Q2 so far has been mixed.
- Our base case is that US GDP will accelerate in the second half, nonfarm payroll numbers will remain above 200,000 additions per month, and wages will accelerate. We note that in-depth studies by Credit Suisse on inflation, and Macquarie, on wage growth, respectively found national data materially underestimated both with Consumer Price Index (CPI) 30-40bps too low, and wage growth closer to 3.6% than 2.6%. Simply put, we think 'reflation' is more probable than 'deflation', and not priced-in.
- Despite a bad week for Trump and GOP, we think sentiment is overly pessimistic policy gridlock will endure all year. GOP are aware of mid-terms in Nov. '18 and will be desperate to score some legislative wins, there is the makings of a bipartisan deal on tax reforms and infrastructure spending via an alliance of moderate GOP Congressional members and parts of the Democrat party and Trump is all about deal-making.
- It is worth noting political risks might mount after Congress's recess ends later in August, as attention shifts to agreeing a deal on the government's debt ceiling and on the FY17/18 Budget that will pitch the moderate GOP faction against their implacable, conservative colleagues with a deal likely to need Democrats' help which will only be given if obtain a trade-off. This debate has

gone to the wire several times before and might well do so again with short term negative implications for SPX, USD and short duration USTs

EU Equities – Review

- STOXX peaked late May on Macron enthusiasm and has under-performed SPX since and on a YTD basis. The strong EURO is certainly one factor but likely, too, the fact it was the consensus overweight equity region since YE16 might have played a role. Rotation has been vicious from bond 'proxies' hit hard, as fears of ECB 'tapering', with Bund yields, up from 23bps to close to 60bps, and exporters, from Euro risks whilst financials have benefitted from developments
- Macro data in continental EU remains robust at a high absolute level but has eroded slightly from the peak in Q2 – Q2 GDP accelerated to 2.1% annualised pace - as momentum may have peaked and inflation remains muted. FI and equity markets have generally taken a 'hawkish' view on ECB despite an explicit message from Draghi, IMF and other ECB officials that it will remain more accommodative than markets assume. In contrast, recent UK macro-data has disappointed, suggesting BREXIT concerns are limiting fixed asset investment (FAI) and that GBP depreciation has not really boosted exports.
- Macron's victory and 'honeymoon' period since might mark the highs in reduced political tension, as Poland's intention to reign-in its communist-era judiciary was seen as an attack on the rule of law by the EC yet its shift towards a populist, more authoritarian political system is shared by other Eastern EU countries – notably Hungary. Italy is also fuming that the rest of EU has provided little help to ease its migration crisis with over 200,000 having landed so far this year.
- FTSE 100 Q2 results, so far, are powering along at +20% year on year (YoY) pace powered by higher commodity prices (UBS sees accounting for 75% of the rise) and a weaker GBP. Politics remains a mess with various Cabinet ministers taking turns to contradict each other on a BREXIT negotiating position as more banks announce plans to shift staff, assets and capital with estimates on BREXIT costing banks an extra $1bn per annum and lowering return on equity (ROEs) by 200bps and require additional capital of $30bn.

EU Equities – Outlook

- Euro's moves will continue to be a key variable but our base case is the rise against USD is overdone and, as greater realism takes over on the divergent monetary policies between the Fed and ECB, this might help STOXX (we see at least ONE more hike by YE17 and 3 to 4 hikes in '18 with ECB only lifting its deposit rate in '19). We continue to expect domestic demand-geared sectors, small and medium enterprises (SMEs) and financials to out-perform, with financials benefitting from re-leveraging, falling non-performing loans (NPLs) and stronger loan growth
- STOXX earnings growth is forecast at +17% Q2, after +25% in Q1. Stronger than expected Q2 GDP might help another 'beat'. FTSE 100 Q2 earnings are beating by 1-2%, helped by its large energy / commodity weightings and by the fact that over 70% of revenues are derived offshore. Should EURO remain at elevated levels, up 12% YTD, this will be a meaningful headwind to earnings in H2FY17 and more FY18 and to GDP with estimates that this would be lowered by 60bps in CY18.

- We think markets have become complacent about the underlying political risks in EU as the explosion in migrant arrivals on Italy's shores has boosted support for anti-EURO, populist parties at a critical time ahead of an election due by May '18. Likewise there is a growing split between several Eastern EU countries, notably Poland and Hungary, and core-EU with latter increasingly concerned over moves to curtail the rule of law and anti-democratic developments more akin with the Russian model. Prospects of a rift with Turkey are growing which could unleash a wider migration crisis for EU
- The Financial Times (FT) suggested a consensus was forming around a Hammond-Davis pro-business BREXIT negotiating position and a transition agreement to be in place on trade for at least 2Y after BREXIT (next election has to be held by '22) but subsequent disharmony within the Cabinet suggests reaching a consensus will prove difficult yet the clock is ticking and the advantage is with the EU. Not surprisingly businesses are not waiting around and investment has collapsed – notably in the car industry.

APAC AND EM Equities – Review

- Despite the volatility in USD/JPY, now testing 110 support, Nikkei 225 has been surprisingly resilient holding around the 20,000 level. This resilience is even more impressive given concerns that the previously unshakeable Abe might be forced to resign, after a collapse to a perilously low level of popularity (below 30%) in a few weeks due to mishandled answers on some land scandals, and so bringing into question Abe-nomics's prospects of success to which Abe is central. Separately, however, Nikkei earnings have led global revisions up during Q2.
- PRC Q2 GDP surprised positively at +6.9% YoY. Latest PMI data has also risen vs. forecast declines. Previously, much hyped fears of CNY devaluation eased further after another month of net gains in FX reserves. There is evidence that mainland retail investors were rotating out of the highly speculative ChiNext SME 'casino' into 'blue chips' listed in HK helped drive Hang Seng Index and H-shares up 5% & 4.5% respectively last month vs. A-shares up just over 2%.
- SAMSUNG Electronics beat forecasts to briefly become the world's most profitable non-financial company in Q2, overtaking APPLE. It single-handedly powered-up HOSPI FY17 earnings growth of over 40% YoY. Q2 overall saw Asia excluding Japan (AXJ) earnings rise to +20% FY17E recording 12 consecutive months of upgrades to July. India is the main exception, with continuing downgrades and several sell-side houses warning of further downgrades of 4-6% for FY3/18. However the switch to Bharatiya Janata Party (BJP), of the ruling party in Bihar, from the opposition alliance, solidifies the prospect that BJP will win in '19 general election
- Russia's central bank cut interest rates. Weaker-than-expected inflation is providing a more dovish backdrop to other EM markets as Brazil, Mexico and Turkey.

APAC AND EM Equities – Outlook

- There is a risk that both Abe and Kuroda, the principal architects of the 'three arrows' of reform, might be out by end April '18. Kuroda's term ends that month. However, the thinking is that for now, there is no obvious alternative to Abe with the opposition fragmented. The most likely challenger, the Tokyo Mayor, lacks a national platform. Analysts also think Kuroda would be reappointed by two of the three most likely LDP successors to Abe. If so, the broad thrust of Abe-nomics would continue, if not refreshed.

- The key political event in N.APAC will be the PRC five year leadership reshuffle. It is expected Xi Jinping will gain complete control of the CCP and thus be in a stronger position to 'force' through required structural reforms. The key is whether Xi overturns the long-held Deng doctrine of a two-term Presidency and if he elevates Wang Qishan, the anti-corruption head, to become Premier (despite being too old at 68).
- In India, record low inflation should allow Reserve Bank of India (RBI) to lower rates later this yea0. This might hurt INR but boost export-geared sectors, such as IT software and pharmaceuticals that have suffered YTD. Malaysia may see an early general election later this year. This might have significance for MYR and equities although PM Najib has gained in political strength YTD
- Politics is important elsewhere in EM. Brazil's Temer faces a full Congressional hearing today on whether he should face criminal charges. This would almost certainly end any hopes of important further fiscal reforms. In Argentina, Macri faces a difficult election with a refreshed opposition. In Turkey, meanwhile, markets like the certainty around Erdogan's almost unchallenged rule post-referendum and the attempted coup.

FIXED INCOME – Review

- UST yields have waxed and waned, but the drum-beat of relentless dovish sentiment remains the overall trend. Events last month showed that only data or Fed comments that suited this narrative moved markets. In a big-picture sense we remain in the multi-year trading range on 10Y UST between 1.75% and 2.6%. Of late the range is between technical support at just under 2.1% to 2.38%, with moves last month in the higher part of the range. Linked to this is the flattening or steepening of the yield curve.
- Bund yields have, on perception that ECB will soon become more hawkish, risen sharply, from a 24bps recent low to test technical resistance at 60bps, on slightly weaker EU macro data, to just below 50bps.
- US IG spreads over USTs are close to record lows, having compressed by 30bps YTD. BB & BBB spreads are below previous record lows, as the hunt for any yield, anywhere, continues unabated, on the back of huge inflows YTD into FI funds and, notably, to credit funds.
- EM yields are now below US HY yields, for only the third time in history. This reflects obvious enthusiasm for all things EM-related this year. It would appear to be at odds to credit risks given the build-up in EM debt and still very strong issuance vs. a more modest issuance in US HY. EM LCD continued to benefit from USD weakness

FIXED INCOME – Outlook

- Views on where UST yields might end 2017 remain polarised between the deflation/ 'secular stagnation' camp, seeing 10Y yield below 2.00%, and favouring longer duration on a flatter yields curve; vs. those in the reflation camp with forecasts closer to 2.75-2.8%. We remain firmly in the reflation camp. We see greater risks in longer duration FI, and more danger for IG than for shorter duration HY. Fed futures, a notoriously poor predictive tool, suggest probabilities below 50% of another rate hike in '17 which is at clear odds to Fed's 'dot plot'.
- The debate, as is the case in EU too, revolves around where inflation is going and the link to a tightening labour market. Simply put, will the traditional Phillips curve model (a model Yellen

and Fed still subscribe to) start to work, and wage inflation start to come through, as it has done on three occasions since WW2? Or are deflationary forces in the ascendant and that there is greater 'slack' in labour markets. No one, including the Fed, knows.

- There is, arguably, more risk in EURO FI given how low yields are with many forecasting Bund yield to be closer to 1% by YE17 (consensus might be nearer to 70-80bps). Italian yield spread over Bunds has been widening. French sovereign spreads have tightened and this might have further to run, given that the risk Italian political risk might rise sharply in the next few months whereas any evidence that Macron is executing on his reform mandate should add to optimism on French FI.

FX – Review

- The past month has been dominated by a sharp decline in the USD against most currencies. Meaningful gains in have been seen in the euro, to 2Y-highs to test in 1.18s. AUD broke out of its 72-78c range. Several AXJ currencies also broke above technical resistance levels, for example SGD and THB. One exception: GBP. The move weaker in USD is not justified by fundamentals, such as yield differentials, but likely more a result of dampened hopes of US policy progress. In contrast witness greater optimism for a renewed Franco-German pact at the core of EU.
- GBP was pulled in different directions as weak macro-data reduced on BOE rate hikes whilst a possible Cabinet consensus around a 'softer' BREXIT, as indicated by the pro-business Chancellor, Hammond, was constructive for GBP yet it under-performed other major currencies to remain within the YTD trading range.
- Asian currencies also strengthened vs. USD with THB at a 2Y-high and SGD breaking convincingly stronger through 1.3750 to below 1.36 now.

FX – Outlook

- Politics and their impact on currencies are almost impossible to quantify. Given the ever-growing dysfunctionality in Trump's administration (surely it cannot get any worse than in July), vs. EU hopes driven by Macron, EURO gains might continue for a period. We are sceptical, as we continue to believe EU faces profound structural problems, such as a lack of fiscal and monetary union. At best, it's a spluttering banking union with ECB likely at the limit of its ability to assist. Populism is not dead despite press columns suggesting it has peaked. The biggest test is to come in Italy's election where anti-EU parties have the best chance of winning of any EU election. Italy is core to EU and to EU's sovereign banking crisis.
- Our base case is that FX and FI markets are too pessimistic on US political gridlock, and too complacent on EU's problems. This will reverse in favour of a stronger USD through to YE17. We continue to believe that the Fed will hike at least one more time in '17 and by three to four times next year. This will emphatically drive home its divergent monetary policy to the rest of the world and against a likely still very accommodative ECB (we doubt there will be any deposit rate rise until '19) and dovish EM and AXJ central banks.
- We think it unlikely that UK's weakening data will allow BOE to hike in '17, if indeed before BREXIT in '19. This would be GBP negative but the key driver will be evidence of any agreed

- Cabinet position on BREXIT- whether it will be 'hard' or 'soft'. In the latter case, GBP could drift up to 1.36-1.37 level.
- RBA has made it clear it will not be tightening any time soon and we see a slower PRC economy in H2 pressurising lower commodity prices.
- In EM and AXJ we see more likelihood of monetary easing than otherwise. This implies a bias toward weakness vs. USD. In particular we see risks to INR if, as is more likely, RBI cuts rates thisyear. Elsewhere in AXJ, Bank of Korea (BOK) in S.Korea, Philippines' Bangko Sentral ng Philipinas (BSP) and Indonesia's Bank Indonesia (BI) are all sounding more 'dovish'. PRC's People's Bank of China's (PBOC) tightening may have peaked. We think Mexico, Brazil, Russia and Turkey might all ease rates from here as inflation falls further.

COMMODITIES – Review

- Oil continues on its roller-coaster rise between the tramlines, for Brent oil price, of $45/bbl. at the low end and $55/bbl. at the higher end. It appears OPEC and its large non-OPEC allies such as Russia feel forced to act at the lower end of the range. We saw this last Monday, when Saudi Arabia unilaterally chose to cut exports, underpinning the price. At the higher end factors limit further upside: there are doubts OPEC can deliver the agreed production cuts; rising production by the US oil and gas industry; evidence 'big oil' have lowered break-evens to around $50/bbl. The last week had it all – a sharp rebound to two month highs before plunging 3% yesterday on data showing OPEC production hit a YTD-high last month.
- Gold has proven resilient in the last month, despite close to record short contracts. It stayed above key support at $1,250/Oz. Apparently it has, to a modest extent, broken its tight correlation to USTs.
- Enthusiasm over stronger PRC GDP growth and related strong commodity import volumes boosted base metals with 'Dr' Copper at a 2Y-high. This also helped AUD and EM equities, as well as FTSE 100.

COMMODITIES – Outlook

- Our base case is that Brent oil trades between $45-55/bbl., but likely more in the lower half. Sell-side analysts have been bringing down short to medium term forecasts in general. There are huge differences over the longer term when 'peak' oil demand will occur. SHELL is working on the assumption it occurs by 2025. IEA says 2040-50, whilst XON doubts it will be this century. The news flow remains remorseless. Governments committing to phasing out internal combustion cars by 2040. Renewables are becoming ever more economically viable. Even major oil companies, such as SHELL again, are seeking to invest more heavily in renewables and natural gas.
- Gold remains an important portfolio diversification in an increasingly risky and uncertain world where traditional FI no longer provides the 'safety hedge'. We are all aware of the known 'unknowns', as US attacking N.Korea, that are almost impossible to 'hedge' in portfolio construction. Gold does provide some protection. We see it trading in a range of $1,100-1,360/Oz. More narrowly there are sellers around $1,300 and buyers below $1,180.