update

Knightsbridge Wealth

Dear Friends and Colleagues,

Mid February saw a nasty slip-up in global stock-markets, only to bounce back by month end. The UK's FTSE 100 had its best week in two years, gaining almost 3%, and the US's S&P 500 index bounced by 4.3%, its best outing in five years. Yet the development that caused all of the fuss – the rise in US bond yields amid signs of inflation returning – hasn't gone away. Indeed, the US ten-year Treasury yield, which is the benchmark for world debt markets, has edged up to a four-year high above 2.9%.

What's more, last week's data showed that in January, inflation as measured by the consumer price index (CPI), jumped by 0.5% and is now running at an annual rate of 2.1%. Price rises have speeded up lately too. Over the last three months, CPI has reached 4.4% year-on-year.

It always takes time for markets to get used to important new trends (equities kept climbing long after the first signs of the credit crisis had emerged in the mid-2000s, for example), and it seems to be a similar story this time. Investors appear to be comforting themselves with the thought that it is still very early days in the shift towards higher interest rates. Indeed, inflation-adjusted US short-term rates are still negative.

Moreover, in other major economies, the cost of money is still at record lows, and central banks continue to create electronic cash. That means there is a huge amount of money still looking for a home. So central banks will provide a tailwind for equities for now. A strong global economy, and high US earnings growth, are also bolstering confidence in stocks.

But as rates rise the cost of borrowing for companies will climb, and the relative appeal of fixed-income investments will also rise. Expectations for US earnings growth are very high: analysts are pencilling in an 18% increase for S&P 500 firms in 2018, so there is 'plenty of scope for disappointment' in the already overpriced US stock-market, as The Economist's columnist Buttonwood puts it. Higher wage and borrowing costs will nibble away at corporate margins.

If inflation does get going, it bodes ill for stocks. Since the 1930s, US stocks have delivered real total returns of 14% per year in periods of falling inflation, but pretty much zero when it has been rising.

Our strategic partner, UBS, remains bullish on global growth, and global equities – particularly the US. However, it is a crucial time to manage investments carefully, looking out for warning signals and a good time for clients to re-assess their own risk profile. It's hard to disagree with Morgan Stanley's view that February's wobble was an "appetiser" and the "main course" is still to come.

We look forward to working with you in 2018.

Our strategic partnership with UBS (Union Bank of Switzerland) gives the best of both worlds – personal service and the ability to react in a way that only a small firm can, partnered by one of the world's most prestigious brands.

Market Report

Bonds

Bond Bull Finally over

Monetary policy is finally becoming more normal. The US Federal Reserve has phased out its quantitative easing (QE) or bond buying programme and now the European Central Bank and Bank of Japan's QE programmes are decelerating too. Britain has started raising interest rates. Central banks had been huge bond buyers. Fears that China may be slowing its purchase of US government bonds – which Beijing denies – has given the selling added impetus.

Yields are edging higher on new issues of bonds, reflecting the need for higher returns as inflation begins to bite. Risk-free yields in major developed markets are near or below zero. Even if rates stay as there are, many short to medium term bonds will deliver negative returns, so market values of existing bonds will inevitably fall. Investors can preserve wealth and take profits on assets delivering negative returns.

Bonds remain a stabilising component of most portfolios, and 10-year treasuries and Emerging Market Bonds, priced in US Dollar, offer compelling yields.

Commodities

Drop in supply is boosting prices

Base metal prices have held up reasonably well in the equity market sell-off. Higher prices are likely for copper (where supply growth is slow because of underinvestment in recent years) and aluminium (linked to supply capacity from China, which is making adjustments to its environmental policies).

Agricultural markers have been flat this year, with sugar and coffee posting the weakest performance, and grains, the strongest.

Gold

The safe-haven asset

In the recent market sell-off, gold out-performed equity markets, confirming its role as a safe haven asset. Rising US inflation and interest rates, as well as political risks, should remain elevated in the coming months, supporting demand for safe haven assets.

Gold is an attractive hedge as part of a wider portfolio. However, upside growth potential is limited, and higher interest rates has historically hurt gold valuations.

Oil

Negative sentiment spreading

OPECs plan to reduce supply, and drive up prices, has been far more successful than usual, and demand for oil continues to be ahead of expectations – fuelled by emerging Asia where roughly half of the world's population live, yet currently accounts for only 25% of oil demand.

However, at these levels, US shale production becomes economical, so supply will increase and, at the same time, ongoing energy efficiency improvements reduce the long term potential of oil's value.

Equities

Energy, Finance and IT look attractive

Regionally, Europe looks particularly good value. Solid economic growth and a moderate rise in inflation provide a suitable background for Eurozone 'value' stocks to outperform the wider market.

Global equities are likely to grow well through 2018. The economic and corporate earnings backdrop is still robust. US earnings growth is on a strong footing and, partly due to tax reform, will rise by 16% this year. A warning sign, however, is that US equities are more expensive than many other regions and are trading at a premium of around 15% over their 30 year average.

Globally, energy should benefit from improving cash flows, because of reduced capital expenditure and cost cutting. Valuations are attractive and come with a healthy dividend. Financials are among the main beneficiaries of globe's return to growth, higher US interest rates and US tax reform. Technology stocks are offering strong cash flow generation at reasonable valuations, with their usual premium now in line with the historical average.

Foreign Exchange

Letting go of the safe haven

The fall in the US dollar has eased recently, but up by less than 2% in recent weeks and still down 12% over the past year. Growing US external indebtedness will keep weighing on the Dollar's value. Its liabilities are now more than 40% of its GDP – a record. To help stabilize the position, a 6-10% broad depreciation is needed over the medium term. The dollar remains overvalued against the euro on a fair value basis.

The solid global recovery is also convincing investors to let go of safe haven currencies. Emerging market currencies and the Euro are likely to strengthen. Sterling is likely to continue its recovery, whilst the volatile nature of the Brexit negotiations will be reflected in currency price movements.

Vietnam – a land of opportunity

The southeast Asian country is gradually shaking off the burdens of its troubled history. To older generations, Vietnam is indelibly associated with the war. To younger generations, it is a compelling travel destination, and to those who have been there, it is a motorcycle race track. The country has a population of 94 million, and 45 million registered motorcycles, which makes crossing the road hazardous, especially when an oncoming vehicle is carrying a family of four and several pigs.

However, Vietnam is still a divided country, with clear differences between the more populated and prosperous south and the more conservative north, where political control resides. In the north, pilgrims queue around the block to visit the Ho Chi Minh Mausoleum and the associated museum, built in the Soviet brutalist style. In the south, Ho Chi Minh commands little respect, it seems.

In the north, they refer to the Vietnam war as "the American war" (but there is no lingering resentment); in the south, they are not sure that they weren't on the losing side. In the north, communism had deep roots; in the south, it lasted fewer than 15 years, suffering from famine and hardship before it started to be dismantled in the Gorbachev era. Prosperity and the appointment of a southern prime minister may have diffused the political discontent, but corruption and cronyism have been problems. Nowhere do entrepreneurs get rich so quickly as in the reforming, or former communist, countries where the government owns all of the assets, but has no money and no business skills.

The differences reflect not just the division of the country between 1954 and 1975, but much more ancient rivalries – the country has been divided before. In the north, they don't like the Chinese, Vietnam's traditional enemy, particularly in the border regions that suffered badly from China's 1978 invasion. This was in retaliation for Vietnam's ousting of the murderous Pol Pot regime in neighbouring Cambodia. In the south, they don't much like the north and, in the middle, where Vietnam's royal family used to be based, they don't appear to much like either. The French, who divided the country into Tonkin, Annam and Cochin, probably got it right.

Surprisingly, the French left more of a mark on Hanoi than Saigon (only tourists and northern communists call it Ho Chi Minh City, locals will tell you) – or maybe the north has preserved it better. While Britain's legacy to its colonial outposts was botanical gardens, exclusive clubs and brown Windsor soup, France's was opera houses, town halls and the baguette. The only legacies left by the Americans are the tasteless glass and concrete former presidential palace in Saigon, which replaced fine colonial-era buildings, and military bric-a-brac sold on street corners, much of it probably fake.

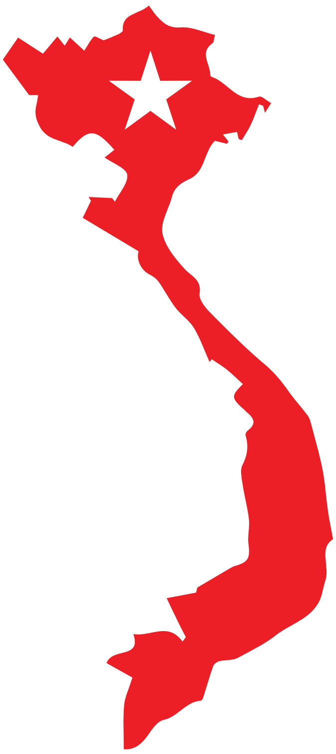
Far more pervasive than the legacies of the past, though, is the evidence of the current economic boom. This is evident not just in the traffic, with cars now replacing the motorcycles that once replaced the bicycles, but in the new houses, offices, factories and hotels that are either completed or under construction. National GDP is now over $200bn, and it has grown by more than 6% a year since 2000. This has spawned a thriving stock-market, on which listed companies hold a total value of more than $100bn.

Vietnam's first stock exchange, based in Saigon, was only inaugurated in 2000. It didn't take long for specialist funds to be established. Investors rushed in, asset values boomed, the economy overheated and the inevitable bust followed, with inflation reaching 20% in 2008.

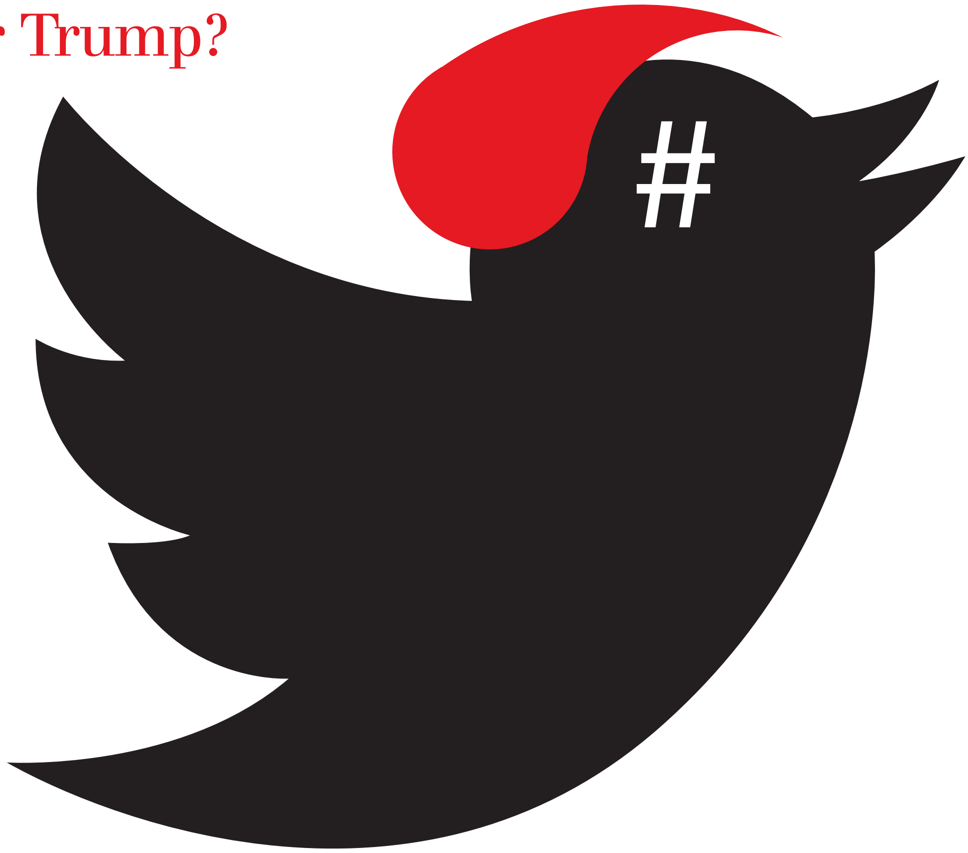
However, the last nine years have seen falling inflation, renewed growth and a thriving capitalist culture. This makes Vietnam a compelling investment opportunity, yet one that is still widely ignored even by emerging-market investors. Manufacturing wages are 40% lower than they are in China, which gives Vietnam a key competitive advantage. Meanwhile, two-thirds of the population is under the age of 35. Its climate, beaches and cultural attractions are a magnet for tourists, it is well endowed with natural resources (most notably oil and gas), and output from agriculture and fishing has been growing steadily. Foreign investment has been strong and the middle class now accounts for a third of the population.

But, as China has persistently shown, booming economies don't guarantee great investment returns. The performance of the MSCI Vietnam has also been erratic with the 12-month return of 44% (in US dollar terms) accounting for nearly all of the five-year return of 53%.

Vietnam is excluded from the MSCI emerging-markets index, as it is still confined to the frontier markets category along with Nigeria and Argentina. To the Vietnamese, this is an affront. But to investors, it may be an opportunity, as inclusion is only a matter of time. When it happens, the passive funds and big investment institutions will have to start investing, which should limit the downside.



Praise for Trump?



US stocks are up by 31%, the most under any president since Roosevelt. There are 2.2 million more jobs. The economy is expanding by more than 3% a year. As President Donald Trump completes a year in office, the other 'Project Fear' – the one that said Trump would tank the US economy – is looking as silly as the first one over Brexit. His significant weaknesses shouldn't blind us to the fact that he may be doing some good.

Anyone looking back at Trump's first year in the White House would surely be struck most by the chaos and disorganisation that has marked his presidency. He is on his second chief of staff, and has had more press secretaries than anyone can count. He has been under investigation for links to Russia, and engaged in a very public row with the FBI. He has blundered his way through foreign capitals, making enemies wherever he goes, and squandering whatever goodwill the US once had.

A blizzard of late-night tweets have verged on the insane, and to cap it all his anniversary of taking office was marked by a government shut-down. Michael Wolff's book 'The Fire and the Fury' is likely to be only the first of many riveting exposés of life inside Trump's inner circle. Yet that has not stopped the economy performing exceptionally well. The Federal Reserve has already raised interest rates twice, with little impact. When Trump, stealing a pledge from his rival Jeb Bush, promised 4% growth on the campaign trail most economists laughed. But it is not far off that now, and may be achieved next year.

One reason, it has to be said, is that Trump has conveniently forgotten many of his more ridiculous policies. If there is a wall being built between the US and Mexico there is no sign yet of any bricklayers starting work. Immigration restrictions have been modest. There is no sign of a trade war with China. He hasn't even nuked anyone – not yet, anyway.

What he has done is push through a pair of big reforms. First, he completed a radical overhaul of the tax system. As the rest of the world steadily cut corporate tax rates over the last two decades, the US left its own where it was. The result? At 37%, it was charging one of the highest rates in the world. Companies were regularly moving abroad to avoid it. Rather than trying to trim that, or introduce a few more fiddly allowances, Trump has slashed the rate way down to 20%. It is one of the boldest single tax cuts since the days of Margaret Thatcher and Ronald Reagan. It already seems to be having an impact, with companies, such as Apple, bringing home billions stored overseas, much of which will end up being invested in the US economy.

Second, he has started to slash red tape in what had turned into one of the most over-regulated economies in the world. In Trump's first year, 22 regulations have been eliminated for every new one introduced, and an executive order makes it mandatory for Congress to repeal two rules for every new one it creates. True, he has had more success in stopping new regulations than the harder task of getting rid of old ones. But he has made an impressive start.

With his mix of self-promotion and personal bombast, he may even have boosted confidence. True, a lot of that is down to luck. Trump inherited a growing economy, and the stock-market was already buoyant before he moved into the White House. But he has also pushed through some effective pro-growth policies. Over in Europe, we should not allow his often obnoxious personal qualities, or the chaotic state of his administration, to obscure the fact that he may well shape up into one of the more successful presidents. Time will tell.

Bad year for London and Landlords

The past year may be remembered as one in which London property finally faltered in its one-way ascent, while the government put more nails in the coffin of buy-to-let. It was also a year in which the shameful exploitation of buyers of new homes hit the headlines, while first-time homeowners got a helping hand that will turn out to be nothing of the kind.

Prices in the capital fell for the first time in 2017, year-on-year, since the financial crisis. London was also the worst-performing region in the country for the first time since 2005.

But the UK market as a whole remained fairly stable. The annual rate of house-price growth has stayed within a 2-4% range since March, according to the latest house price index from Nationwide. The average house will now cost you £209,988, up 2.3% in 2017. The abolition of stamp duty for first-time buyers probably garnered the most headlines of any of the announcements in November's Budget. Philip Hammond announced that first-time buyers would no longer pay stamp duty on the first £300,000 of any home costing up to £500,000. The change should save £1,640 in stamp duty for the average first-time buyer buying a £210,000 property.

Unfortunately, the Office for Budget Responsibility reckons house prices will go up by 0.3% over the next as a direct result of the cut, as prices tend to go up to the level that people will be able to afford.

'Fleecehold' firmly established itself in the national consciousness over the past year. Homeowners' campaign groups originally drew attention to the controversy, which involved owners of flats and some new-build houses locked into leasehold agreements containing onerous ground-rent clauses. In some agreements, ground-rent charges are set to double every 25 years (the oft-quoted example was of a ground rent starting at £250 per year that would reach £69trn by the end of a 999-year lease). Where homeowners tried to buy their freehold from the freeholder, they then often found that the developer had sold it on to a professional ground-rent investor, who had since jacked up the price. The government has proposed a ban on the sale of houses as leaseholds in England and the introduction of restrictions on ground rents.

There was also growing and long overdue scrutiny of the shoddy quality of many new-build homes. Buyers have been left in properties with faulty wiring or drainage systems, or unable to move in at all. The government says it will also consult on the quality of new-build homes in 2018.

Finally, it's been another bad year for buy-to-let landlords, following a tough 2016 in which the government introduced a higher rate of stamp duty on second homes. Last April saw the start of a progressive reduction in tax relief for interest on mortgage payments. Landlords can now fully offset just 75% of their interest payment against rental income, with the remaining 25% only available as a basic-rate tax reduction. By 2020, the entire payment will only be available for relief at the basic rate.

Meanwhile, the Bank of England has also put in place stricter affordability rules for portfolio landlords (those that own four or more mortgaged buy-to-let properties) meaning that lenders now have to look at the financial viability of every property in a portfolio when deciding whether or not to grant a mortgage, rather than looking at overall accounts. Monthly rental income now also needs to cover 25% of landlords' mortgage payments, stress-tested at an interest rate of 5.5%. None of this bodes well for a renewed boom in buy-to-let.

One of the well-publicised results of market falls is Creswell House, an extravagant home in the Bolton's area of West London. It was originally marketed at £37.5m in 2016 by well-respected property agents, Knight Frank and Savills. It is just been put back on the market at £20.1m. The repricing comes as foreign buyers cool on London, largely because of the tax changes.

Dark Clouds gather over Housebuilders

Persimmon, Britain's largest house-builder, faced a backlash recently when it was revealed that an ill-considered incentive scheme for its chief executive put him in line for a £100m bonus, the UK's most generous such payout ever. In total, it will award almost £800m to roughly 140 senior staff. Persimmon is not the only housebuilder handing out huge bonuses, and shareholders may well question whether they're happy to stick with firms that spend so much of their profits on lining executives' pockets.

But beyond the vexed issue of pay, it's fair to say that housebuilders have been a good bet for investors. Last year, the sector outperformed the FTSE All-Share by about 30%. That was partly because share prices started at low levels due to uncertainty following the vote to leave the EU, but they've been a good long-term bet too – anyone who had owned Persimmon for the past five years, and reinvested their dividends, would have made almost 270%, compared with just 41% for the FTSE All-Share.

The question now is – can the good times continue? There are signs the bright picture might be about to darken. House-price growth in the UK and in London, in particular, is slowing, while rising costs are squeezing builders' margins. Last month, fund manager Mark Swain of Smith & Williamson announced that the firm was 'short' (ie, betting on share-price falls) on a number of housebuilders, and long only on one – Bellway. Swain notes that there are several headwinds for investors: no extension of government help-to-buy subsidies, which are set to end in 2021; a potential government investigation into 'land banking', where housebuilders artificially restrict supply by holding on to land rather than starting on new developments where permission to build has been given; a shortage of skilled workers; and high valuations.

The big risk is that housebuilding right now finds itself at the sharp end of both politics and economics. Government support and ultra-low interest rates have helped the sector for many years, driving profit margins to record or near-record highs. But monetary policy is tightening now, while a cavalier attitude to voters' views on excessive executive pay won't convince the government to renew its help for the sector.

A new dawn for emerging markets

Emerging-market equities spent much of this decade treading water, but since early 2016 they have been making up for lost time. The benchmark MSCI Emerging Markets index has jumped by 60% since January 2016, and the outlook remains favourable. Indeed, we could be seeing a 'new dawn' for the asset class, according to fund-management group Barings.

Growth in developing countries has rebounded after a slowdown caused by the end of the commodities boom, recessions in Brazil and Russia, and lacklustre growth in industrialised countries. Now, with the global economy finally accelerating, many developing countries have achieved their best growth rates since 2012; the PMI gauge of manufacturing activity across the asset class is near a six-year high.

A rise in inflation, partly caused by a slump in emerging-market currencies a few years ago, has been overcome. As central banks have squeezed out inflation, they have gained scope to cut interest rates, stimulating growth. Brazil is a prime example. Inflation has dwindled to a record low and the main interest rate has halved to 7%. All this has given corporate profits a welcome boost after five years of shrinkage. Bank of America Merrill Lynch is pencilling in a 22% increase in earnings per share for the MSCI index this year; its 2018 forecast is a gain of 13%. Valuations, meanwhile, are still below the historical average.

This is a positive backdrop, but emerging markets will always be at least partly beholden to events in the developed world. Market optimists note that growth depends less on exports to Europe and the US these days, and more on China and internal markets. But arguments like this have meant little during previous global shifts to risk-off psychology. Emerging markets are unlikely to decouple if there is a global sell-off. A key headwind will be higher interest rates in the US, which, along with the resulting rise in the US dollar, always draw money away from riskier assets. Unexpectedly fast rate rises caused by the return of inflation (see below) could shake confidence in developing countries, while the Trump administration could damage trade-dependent countries' prospects if it resorts to protectionism.

Still, higher US rates should not have too much of a knock-on effect. Most emerging-market debt is denominated in local currencies these days, not dollars, so there won't be much of a jump in debt-servicing costs. Provided the global economy can keep going, emerging markets should, too. Concentrating on countries with big domestic markets and solid long-term prospects such as India and the Philippines may help investors stomach the inevitable volatility.

Knightsbridge Wealth's senior team and support staff have over 200 years experience in the world's largest Banks

Alexander Wade

Alexander is one of the most experienced London advisers in the international market, specialising in this field over the last 20 years at HSBC, consistently recognised as one of its most accomplished advisers. He has over 24 years' experience in financial services. He is particularly interested in the Middle East market and understands the specific issues which are relevant there.

Stuart Poonawala

Stuart has worked in financial services since 1998. In 2003, he helped to found HSBC's specialist London arm advising international clients which quickly became one of the bank's most successful UK divisions. In 2009, he launched Kubera Wealth, our sister company, focussing on providing quality advice to the UK market.

Graeme Cowie

Graeme is responsible for building our professional connections with international lawyers and accountants, as well as co-ordinating our relationship with key fund managers at a number of international Private Banks and Discretionary Fund Managers. He has spent over 20 years in financial services and investment management, most recently spending more than six years at UBS where he led the Strategic Partnership team.

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