update

Knightsbridge Wealth

Dear Friends and Colleagues,

At the start of the year, investors were full of questions about Catalonia, Saudi Arabia and President Donald Trump. Six months on, questions are around volatility, Italy, North Korea... and President Trump.

Global corporate earnings in the first half of the year were an impressive 9%, yet volatility is back. Italian elections, turmoil in Brazil, Turkey and Argentina has renewed fears about protectionism, and kept uncertainty high.

A key question for the second half of the year will be whether US economic strength will translate into greater wage growth, high inflation and steeper interest rate hikes than expected. For the moment, there are few signs that inflation is rising markedly but it will pay to be watchful.

Some slowdown in China is inevitable. Property sales are slowing and infrastructure investment is weakening. In Europe, can the Euro-zone maintain its impressive growth rate now that the Quantative Easing programme is ending, translating into higher borrowing costs and reduced investment.

Overall, it is hard to be too negative on global equities but investors need to prepare for this environment by staying invested to benefit from economic growth, but diversifying globally.

In the UK, property has long been a favoured investment that is now falling out of vogue, with prices slowing or falling, and no longer tax efficient for the international investor.

Since the last 'update,' the new non-domicile rules have been put in force, and they take retroactive effect from 6 April 2017. Although there had been some call for these rules to be delayed, this confirms that the Government's project to reform the tax rules for non-UK domiciled individuals (non-doms) is being implemented.

The previous inheritance tax 'deemed domicile test' has reduced from 17 to 15 years, and UK residential property has been fully brought into the scope of UK inheritance tax, regardless of how it is held. This means that many of the expensive trusts and corporate vehicles that have had been set up in the past, are being wound down. A grace period has been announced for those needing to unravel offshore mixed fund bank accounts, to segregate capital and income, whilst protections and reforms have been announced for offshore trusts.

Whilst these announcements represent mixed news, particularly the retrospective nature of the changes, it does finally allow taxpayers to proceed in earnest in readiness to ensure their affairs are structured correctly.

The importance of obtaining high quality advice, in a well-regulated financial centre, has never been so important for international clients.

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
Interest rate rises depress values
Equities provide better risk-adjusted returns than credit at this stage in the business cycle.

While emerging economies are still growing at a decent level, and inflation remains relatively low, emerging market government bonds have been adversely affected by Dollar strength. Signs of a slowdown in activity in some of the larger nations have weakened the near-term risk-return outlook. USD Treasury Bonds still look preferable to cash over a 10-year term.

Commodities
Gold
Trading around $1.375/oz over 6-12 months Gold is broadly flat for the year as early gains have been eroded by unexpected US Dollar strength. However, over the longer term, gold is a sound portfolio hedge and helps to reduce overall portfolio volatility, while the asset itself can easily have volatility of 10% to 20%.

Equities
Values at long term averages
Corporate earnings growth of around 15% year-on-year supports global equities. US companies, which make up around half of the global stock market, are benefiting from tax relief, a fiscal spending package and healthy domestic and global demand.

By Price-Earnings ratio, the global stock market valuation is around its long-term average. Recent strong performance in Canada make it right to take profits but Swiss equities have lagged and prices look attractive at current levels. Emerging market risks have increased.

Oil
Venezuela's production sliding
Already in free-fall due to under-investment and mismanagement, the addition of US financial sanctions will likely keep Venezuela's production on a downtrend, sliding towards 1 million bpd (barrels per day) from 1.4m bpd today.

Meanwhile, Iranian crude exports are likely to drop by up to 0.5m bpd from 2.5 bpd currently. To offset these declines, OPEC and its allies to increase production, although it will still remain in deficit this year. Brent oil prices are likely to move to $80-$85 a barrel in the second half of 2018. Investors with a high-risk tolerance could continue to sell the downside risks in crude oil prices or add long exposure to benefit from the current price uptrend.

Hedge Funds
Diverging policies support performance
Hedge Funds are a useful source of return and stability in a multi-asset portfolio, especially during times of market volatility. They offer superior risk-return compared to other asset classes and access to uncorrelated investment opportunities, which provide downside protection and diversification benefits.

Heightened stock dispersion, low cross-asset correlation, rising interest rates, moderately higher volatility, and diverging monetary and economic policies are supporting performance. Annual returns in USD are likely in the region of 3-6% this year.

Foreign Exchange
Euro, Yen and Pound to appreciate
The European Central Bank's decision to end Quantitive Easing at the end of this year weakened the Euro. An increasing value would be a natural correction from the current trough.

The Japanese Yen is likely to appreciate again as the Bank of Japan will have to lean toward policy normalisation in the second half of the year. The conditions for Yen strength in 2018 are similar to those seen in the Euro in 2017, when the currency rebounded sharply despite the central bank being in the early stage of tightening.

With politics at the forefront again, Sterling has become cheap again and a rate hike by the Bank of England cannot be ruled out. Brexit uncertainty has risen again due to political quarrels. Assuming a cliff-edge Brexit is avoided, Sterling is likely to rise with investors switching their heavy positioning away from the USD and to Sterling.

UK house prices continue to steady, whilst London falls

The consensus outlook for UK house price growth in 2018 and 2019 is about 2-3% per year. Growth has been slowing in recent years, and rose 4.2% in the year to March 2018, according to new data from the Office for National Statistics.

London house prices have lagged UK house prices for the past 15 months. The average London price is down 1% in the past year to March, whilst the UK is up 4%. Meanwhile prime central London, according to Knight Frank, is down 1.4% year on year to May, and 7% since the peak.

Risks to the UK housing market remain the economic backdrop, mortgage rates, changes in the value of the currency; and regulation.

Following the introduction in 2016 of the additional 3% stamp duty surcharge on second homes, and the staged removal of mortgage interest deductions from 2017 to 2020, the proportion of Buy-to-Let investors in the New Build market has fallen.

The Buy-to-Let investor has to an extent been replaced by the Help to Buy investor. Currently the Buy-to-Let investor accounts for 16% of new UK mortgages, down from 20% just over a year ago. With Help to Buy investors now accounting for 40-50% of New Build purchases of private completions, the Help to Buy scheme is underpinning the new-build market, though there must be some concern about what will happen as we approach 2021 – the current lifetime of the Help to Buy scheme.

With approximately 80% of Help to Buy purchases being made by first-time buyers, the first-time buyer is to an extent replacing the Buy-to-Let investor.

Although mortgage approval data shows a relatively slack trend, the forward looking new buyer enquiries for the UK have recently shown signs of recovery. After 13 months of consecutive negative new buyer enquiries, the metric may indicate an end to this negative trajectory.

The most likely cause of the significant underperformance of London housing is higher prices and thus lower affordability; with less benefit from government incentives and greater impact from the tax changes in the past few years.

Broadly speaking it seems as though the more expensive boroughs are also the worst performing. While the cheaper boroughs are of the best performing boroughs, looking at both the one year and one month change in prices. This is also reflected in the change in transactions, over the last five years. The five most expensive boroughs of London have experienced on average a 39% fall in transactions, while the five cheapest boroughs have had an average increase of 32%.

The universal assumption in the UK is that bricks and mortar are a good long-term investment. This explains the anxiety about the young not being able to get on the property ladder.

The government forecasts that the number of households in England will grow at an annual rate of 0.8% to 28 million by 2039, averaging 210,000 a year. The data suggests that the decline in the number of people per household has flattened out and immigration is down, so household formation could be significantly below the government's forecast. However, there is pent-up demand from 'concealed' households of at least two adults living within another household and of stay-at-home adults. This will underpin demand for some time.

Given low interest rates, affordability for house-buyers is currently pretty good, despite high prices in many areas. There can be little doubt that the long-term trend of interest rates is now upwards, so affordability will deteriorate. Rates may not be going back to their 15% peaks of the 1970s and 1980s, but a rise to 5% is likely in due course. This will suppress prices, even though steadily rising earnings will help affordability.

Taxation is another negative factor. Housing may be free of capital-gains tax for owner-occupiers, but stamp duty has risen for all but the cheapest properties from just 1% a generation ago to a scale ranging up to 12%. The tax deductibility of mortgage interest has gone and taxation on second homes or Buy-to-Let has been significantly increased. There is more to come; even if Jeremy Corbyn never makes it to Downing Street, a successor government of any colour is likely to significantly increase council taxes and may introduce a property value tax. Finally, the process of house buying has become immensely bureaucratic, time-consuming and costly.

Buying the right property in the right location will always be a good investment, while those buying a house for the long term will, rightly, not be concerned about the prospect for changes in value. They need be in no hurry; the era of rapid house-price inflation is over, so they can afford to wait for the right property, even if that means continuing to pay rent that is higher than the cost of buying.

Those buying for capital gain should realise that the stock-market has been a far better place to invest, with an annualised increase in the MSCI All Countries World index in sterling of 6.9% over ten years and more than 10% over three.

This looks unlikely to change.

Recovery in Greece

After suffering the equivalent of America's Great Depression – a 25% fall in GDP – since its debt crisis began eight years ago, and three emergency bailouts, Greece is now finally emerging from its financial rescue programme. It exits the European Union and International Monetary Fund's bailout package in August.

The recent EU deal stretched deadlines on Đ100bn of bailout loans. The repayment period has been extended to 2033; the grace period for interest payments has also been pushed back by ten years, so the average loan maturity is now 40 years.

Some of the last tranche of bailout cash will be allocated to servicing debt. The upshot is that Greece has very little to repay in the near term and enough reserves to run the country for nearly two years.

But the good news ends there. Greece 'is swapping bailout hell for eternal purgatory', according to one observer. It will have to keep a tight lid on spending for years: the Europeans have insisted on a primary budget surplus (before interest payments) of more than 3.5% of GDP. That is three times the eurozone average and many would question if that is actually achievable. After that – until 2060 – the primary surplus falls to 2.2%.

Throughout the years, every plan to deal with Greece's recurrent drama was heralded as the ultimate solution.

It never was and this one, despite EU economic affairs commissioner Pierre Moscovici's insistence that "the Greek crisis ends here", will also prove a false dawn.

As usual, the plan is based on forecasts of strong growth and large budget surpluses that are likely to prove too optimistic. Greece doesn't have a hope of growing fast enough to work off its unsustainable debt pile of 180% of GDP. This package has alleviated but not solved the problem; the debt burden has just been pushed further into the future. At some stage, however, either a managed 'haircut' or a disorderly default seem inevitable. A managed debt reduction would be the preferable option.

The economy has returned to growth, but still looks fragile. The 2% growth rate depends on ultra-long debt maturities and low interest rates. The banking system is still grappling with bad loans. Unemployment remains high at 20%; corruption is endemic. Political support for ongoing austerity is hardly guaranteed either. An unpopular pension reform, due to be implemented next January, will test people's inclination to make further sacrifices.

Once again, Europe has bought itself some time. And once again, a problem is being managed, not resolved.

Trade war threatens global growth

Look at the headlines, and you would struggle to believe that the global economy is in good health. President Donald Trump continues to fire off volleys in his trade war, throwing financial markets into turmoil and drawing retaliation. The Federal Reserve is raising interest rates—an activity that usually ends in a recession in America. Tighter credit and a rising dollar are squeezing emerging markets, some of which, such as Argentina, are under severe stress.

Yet the world economy is thriving. Growth has slowed slightly since 2017, but still seems to be beating the pace set in the five years before that. America may even be speeding up, thanks to Mr Trump's tax cuts and spending binge. A higher oil price, which in past economic cycles might have been a drag, is today spurring investment in the production of American shale. Some forecasts have growth exceeding 4% in the second quarter of 2018.

This sugar rush, however, brings dangers. The first is that it provides temporary political cover for Mr Trump's recklessness. The second is that, if America accelerates and the rest of the world slows, widening differentials in interest rates would push up the dollar still more. That would worsen problems in emerging markets and further provoke Mr Trump by making it harder for him to achieve his goal of balanced trade.

The trade war is the biggest threat to global growth. Last month, the White House confirmed that a 25% tariff on up to $50bn of Chinese imports would soon go into effect. Three days later, after China promised to retaliate, the president expanded, by as much as $400bn, the other goods America is threatening to tax. If he follows through, 90% of roughly $500bn worth of goods imported from China each year will face American levies. Meanwhile, the European Union is poised to impose retaliatory tariffs in response to America's action against EU steel and aluminium. No wonder markets have caught the jitters.

The president is unafraid of escalating trade disputes because he believes he has a winning hand. America buys from China almost four times as much as it sells there, limiting China's ability to match tariffs. The White House hopes this imbalance will lead China to yield to its demands, some of which are more reasonable than others (shrinking the bilateral trade deficit).

But Mr Trump overestimates his bargaining power. If China runs out of American goods to tax, it could raise existing tariffs higher. Or it could harass American firms operating in China. More important, the president appears blinded to the damage he could inflict on America. He thinks it is better not to trade at all than to run a trade deficit. This mistake also dictates tactics towards Canada, Mexico and the EU. Mr Trump could yet withdraw from the North American Free-Trade Agreement and slap tariffs on cars.

The problem is not that America depends on trade. It is a big enough free-trade area for the eventual damage, even from a fully-fledged trade war, to be limited to a few percentage points. Such self-inflicted harm would impose a pointless cost on the average American household of perhaps thousands of dollars. That would be bad, but it wouldn't be fatal.

The bigger issue is the vast disruption that would occur in the transition. America's economy is configured for designing iPhones, cars and planes - not assembling their components, which cross national borders many times before the final product is ready.

Some analysts attribute Mr Trump's presidency to the economic shock from trade with China after 2000. The turmoil caused by reversing globalisation would be just as bad. One estimate puts American job losses from a trade war at 550,000. The hit to China would also be severe. Any adjustment would be prolonged by Mr Trump's unpredictability. Without knowing whether tariffs might rise or fall, what company would think it wise to invest in developing new supply chains?

It is difficult to imagine such a realignment without a global recession. Tariffs temporarily push up inflation, making it harder for central banks to cushion the blow. The flight to safety accompanying any global downturn would keep the dollar strong, even as America's fiscal stimulus peters out after 2019.

The trade war may yet be contained, to the benefit of the world economy. But America is the engine of global growth. And Mr Trump is an unpredictable driver.

China in bear territory

The Shanghai Composite index has fallen by a fifth since its latest peak in January, thus slipping into official bear-market territory. Investors are nervous: while so far there is little evidence that the trade war between China and the US is hurting either economy, both sides are refusing to back down. China may soon face restrictions on investments into the US, and the next round of tariffs on goods will affect more producers.

A bigger problem for China, however – for now, at least – is its own business cycle. Export growth has softened because the synchronised global recovery seems to have encountered some headwinds. European and Japanese economic momentum has faded. The government has been slowly clamping down on domestic credit growth in recent months; it is now at its lowest level since 2006.

The government's aim is to temper the lending slowdown rather than reverse it; it remains worried about the towering overall debt pile.

A slowdown will revive concern about the structural issues China has put off, says Capital Economics – excess capacity in industry and housing, for instance. This inauspicious backdrop explains why the yuan is on the slide. With some foreign investors selling out, China has caught a dose of emerging-market fever.

Emerging Markets face turbulence

The latest fuss over protectionism is especially worrying for emerging markets. Developing countries are totally dependent on global growth, since their exports usually account for a larger share of GDP than more advanced economies. So, when Trump threatened more tariffs, an index tracking major emerging-market currencies, slipped to its lowest level since he won the White House.

So far this month, the Turkish Lira has lost another 1% against the US Dollar. The Australian Dollar, deemed a barometer of Chinese and global growth, has fallen 0.7%. It hardly matters that emerging market export growth has cooled anyway recently. After surging to a six-year high in 2017, the US Dollar value of emerging market exports grew by just 11.4% in March, the weakest pace for 16 months. If there is a trade war, growth will be weaker in the next few years.

On the plus side, however, emerging markets have got their act together. Since the Asian crisis of the late 1990s, emerging markets crises have tended to be isolated rather than systemic events. Crucially, most developing countries have reduced their vulnerability to external shocks: the countries most dependent on external financing, Argentina and Turkey, are already in the markets' sights. Most others have kept a lid on foreign currency debt, and got better at targeting inflation and reducing public borrowing.

Risky assets always tend to fall at once when there is a panic, but this implies a chance to buy cheaply, assets from countries with big domestic markets and promising prospects. India, Brazil and the Philippines should be amongst the favourites.

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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