***INVESTMENT NOTES: WEEK OF DECEMBER 2-9, 2018***

*Written by Jane Siebels, Global Opportunities Fund*

Last week was very eventful as we predicted. Our predictions were also met- the Fed became much more dovish, the US/China trade negotiations produced a truce and oil rallied from OPEC changes. Therefore our long US equity did well, our long oil stocks did well, our China A shares did well and our covered USD was neutral. This week troubles in Europe take center stage. Considering the headlines in the UK newspapers, we are surprised by the resilience of the UK equity market and the pound. December 11th is the date when Parliament votes on the Brexit plan. It remains to be seen if the Labour Party will vote against just to force a vote of no confidence and a general election. It looks like the Scots and the DUP will vote against and of course the Tory Brexiteers. Or will all the Tories at the last minute decide a Corbyn would be worse? The Bank of England produced a frightening report on their predictions for a hard Brexit. It seems to us that the almost two years could have been better put to use to prepare for an actual Brexit rather than the uncertainty of negotiating. We guess this is what happens when government and civil servants are put in charge of negotiations- mole hills become mountains. It is unfortunate that business leaders and groups of trade commissioners weren't used to plan the actual Brexit as would have been done under the American system.

Both France and Germany are facing their own challenges. For France, the Yellow Vest movement is quickly becoming a violent movement for revolution. We would not want to be Macron right now. Germany's party convention is on the 7th and will decide who will take over from Angela Merkel (who seems to have eyes on the Presidency of the European Union). In both cases we don't think outcomes will be further reflected in stock markets. However, we don't believe the trend of European underperformance will end anytime soon.

Although talk of revolution, changing a leader of 18 years and a major economic power leaving the EU should be influencing the market, it appears as though the inversion of the US yield curve is more important since yield curve inversion is typically a predictor of a recession and of course, lower interest rates in the future. The Fed in its inaugural Financial Stability Report last week highlighted the level of junk bonds and leveraged loans that we have pointed out many times in our investment notes. The Fed seems more concerned about Brexit than the market and said it was an example of an external shock where "the resulting drop in asset prices might be particularly large." They also pointed out that commercial real estate values were growing faster than rents.

We sold our US TIPS (the inflation indexed note) as inflation seems to be trending lower. Steady to lower rates are forecast by the EuroDollar curve into 2021 with a terminal Fed Funds rate of around 2.5%-2.75%. As of the September FOMC, the 2020 dot plot showed the majority around 3.625% and all predicting between 3.125%-3.625%- so the current numbers are a substantial change. Is this the result of a lower oil price? We don't think so as the U.S. economy now consumes just 0.4 barrels of oil to produce $1000 of gross domestic product which is down from 1.1 barrels in 1972. We believe the answer is that the economy is more sensitive to higher rates post the GFC and growth is declining quicker.

Two last points of caution: the Bloomberg systemic risk measure, that gauges the herding tendencies and market exposures among hedge funds, is at levels last seen in 2008 and isn't far from the all time high reached in 2006. The other cautionary point is that our friends at Cantor Fitzgerald are predicting that high yield bond spreads move from the current 390 basis points to 500 basis points in 2019 as defaults rise. We continue to short the high yield market.

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