BENTLEY REID

INVESTMENT VIEWS

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A VERY HAPPY CHRISTMAS
& PROSPEROUS NEW YEAR

EQUITIES	: US stocks soar on the "Trump pump" as emerging markets retreat
BONDS	: Global bonds slump as inflation expectations rise
CURRENCIES	: Sterling is resilient as the US dollar rallies sharply
COMMODITIES	: Gold tumbles on higher $ rates as industrial metals rally

Brexit, Trump and Renzi's referendum; each outcome challenges the established political order, with a crowded 2017 election calendar to follow. It is difficult to look through all the related noise, especially given the political aspects. As such, we have tried to stand back and look at the underlying trends, trusting in valuation as our rock as the investment seas swell.

In this regard, if you ignore the tumult, it seems that we are simply coming to the end of an economic cycle. Feeble, sub-par and moribund, but it is finally drawing to a close. Due to the artificial markets borne of two decades of Central Bank intervention, investors are forgetting that there are cycles. QE may have delayed this reality but it has not abolished it.

As the economic expansion matures, unemployment is low, averaging just 4% in the US, UK, Japan and China. It is also as low as it is going to go in the EU, absent structural improvements; 5% unemployment in the US is akin to 10% in the EU. Both are at levels where effective stimulus, in whatever form, could breed inflation as excess capacity is low.

As we head into 2017, inflation is set to rise. Fiscal policy was becoming more accommodative (or less austere) in most nations, even before the advent of pro-growth "Trumpenomics". The new UK Government has relaxed its deficit discipline and promised more infrastructure spending; several key EU nations are exceeding their 3% budget deficit ceilings (eg. France, Italy and Spain) and Japan continues to prime the fiscal pumps. Only China is acting as a modest dampener as it deals with the fallout from aggressive stimulus in early 2016. Furthermore, year on year oil price comparisons will turn positive in the first quarter; at the time of writing, West Texas crude is trading 47% higher than its January 2016 low. The deflationary impact of a tumbling oil price is now over. Rising minimum wages in the UK and US and ageing, shrinking working populations complete the inflationary picture.

Turning to fiscal policy, this is usually initiated to offset recessionary conditions, when an economy has plenty of excess capacity. This is not the case in the US; quite the opposite. Given the slump in productivity and tight labour markets, Trump policies risk generating more inflation than growth. Indeed, if he deports millions of immigrants and delivers on his anti-trade rhetoric, lower taxes and infrastructure spending would stimulate an economy that he is simultaneously robbing of capacity. Therein lies inflation.

Set against this inflationary narrative, we have elevated indebtedness, a strong dollar and rising rates. Markets have moved to rapidly price in the inflationary impact of Trump's campaign promises, well in advance of their economic effect. Even if the Washington machine expedites relevant legislation, the positive upshot of tax cuts and infrastructure spending will not be felt until late 2017 at the earliest. In the meantime, the US dollar has already risen 5% against its major trading partners, a move that will choke off export demand and reduce the dollar value of overseas profits. At the same time the 10-year US treasury has lost 5% of its value as its yield has spiked to 2.4%. That may seem like a modest move but many forms of debt price against the US treasury curve; the cost of the benchmark US 30-year mortgage, for example, has already risen from 3.3% to 4%. As importantly, any sign that debt finance is going to become more expensive further threatens the profitability of corporate America; not a good thing when US stock market valuation metrics (median PE, price-to-book and price-to-cashflow) all stand at generational highs (source: BCA). Having binged on cheap debt to finance share buybacks and enhanced dividends, US firms come to the end of this cycle underinvested and heavily indebted. Bank of America estimates that investment grade US companies now have net debt equal to 2.4 times their core profits (EBITDA, for the technically minded). This is the highest since 2002 and reflects the fact that US corporate debt has risen by 75% over the last decade to $8.4trn (source: SIFMA).

The stronger dollar and rising rates also have a wider, global aspect to them. Export dependent emerging markets are selling off due to the threat of anti-trade Trump policies. They are also being pressured by a strong dollar and higher US rates that make their significant US dollar debts less affordable. The precise size, duration and ownership of these debts are difficult to judge; research varies widely. However, if both key metrics continue to rise, it will surely act as a restraint on global activity.

On balance, given the maturity of this economic cycle and the over-indebted nature of companies and countries, there is every chance that real growth disappoints as inflation and rates start to tick up in early 2017; faced by rising costs and political uncertainty, companies will remain defensive. Thereafter, there seem to be three possible outcomes.

Trump's fiscal measures may arrive in a timely, measured way, supporting another year or two of modest economic expansion. Rising inflation would gently reduce the real value of the nation's debts. This is the best case scenario. Alternatively, the strong dollar and higher rates could bite before Trump can implement his strategy, derailing the US expansion. Inflation could fall back as growth slows and oil price comparisons wash through. However, under a third scenario, with labour markets tight and politicians keen to reward disgruntled electorates, scarce workers could well demand and achieve higher wages as prices rise in 2017, triggering a wage/price spiral. Rates and the dollar could rise further as investors anticipate higher inflation, choking off activity. Trump policies would deliver inflation and little else. As we consider which outcome will prevail, the 10 year treasury yield and real wage growth seem key; how far and fast each rises over the coming months will serve to inform.

For now, we remain cautiously positioned whilst actively looking for cheap, unloved assets. Conversely, even after the recent sharp sell-off, the yield on nominal bonds remains unattractive, given the inflation backdrop. Finally, US equities offer a very poor risk/reward, given the rising dollar, higher rates, peak margins and historic over-valuation.

IN OTHER NEWS…

Collin's Dictionary has named "Brexit" as its word of the year. First used in 2013, use of the word increased at an annualised rate of 3,400% in the run up to the June vote. Such rapid adoption is "unheard of" since Collins began monitoring word usage. Several of the runners up illustrate how our interactions with social media and mobile devices are shaping our behaviour.

JOMO – the joy of missing out. Pleasure gained from enjoying one's current activity without worrying that other people are having more fun.
Sharenting – the habitual use of social media to share news, images etc of one's children.
Snowflake generation – the young adults of the 2010s, viewed as being less resilient and more prone to taking offence, than previous generations.

EQUITIES

Donald Trump's unexpected victory catalysed a sharp rally in US equities and the US dollar; bonds sold off. President-elect Trump won 306 electoral colleges compared to 232 for Clinton, despite losing the popular vote by a narrow margin (47.4% to 47.7%). Key states such as Pennsylvania, Florida, Ohio and Wisconsin all turned Republican. In yet another bloody nose for the polling and pundit industries, "The Donald" reached out to disaffected constituents and dominated the media through his (over) active twitter account, eschewing traditional advertising channels.

Financial markets moved swiftly to price in the promise of looser fiscal policy. The S&P rallied 4% whilst the Russell 2000 small cap index jumped 12%; the latter is seen as an outsized beneficiary of proposed lower US tax rates. Trump has talked about reducing corporation tax to 15%, although the Republican blue print speaks to 20%. The inflationary impact of such measures and Trump's plans to boost Government infrastructure spending led to an immediate sell off in US government bonds. Financial stocks rallied sharply as a steeper yield curve tends to benefit bank margins. Goldman Sachs, Bank of America and Morgan Stanley all rose by over 20%. As widely reported, Trump has prioritised a withdrawal from the TPP trade deal and has talked of reducing illegal immigration and rolling back environmental restrictions. It will be interesting to see how much campaign rhetoric survives the realpolitik of governing.

The more optimistic market participants have suggested that Trump's pro-growth plans are akin to Reaganomics which heralded an 18-year equity bull market. However, as Professor Robert Shiller has pointed out, this ignores the current market backdrop. When Reagan came to the office in 1984 the US stock market was trading at a cyclically adjusted price earnings ratio (CAPE) of 8; 10-year government bond yields stood at 14%, with the economy in recession. Today the US market stands on a CAPE of 27 times with bond yields offering less than 2.5%. We will need to see a sharp pick-up in economic growth, in particular US consumer spending, for US markets to justify their current valuations.

European markets gave back some of their recent gains in November, undermined by political angst. In the UK, the High Court ruled that there must be a parliamentary vote before Article 50 can be triggered; the FTSE fell 3% last month. On the European mainland Sunday 4th December loomed large as the date of both the Italian referendum and the Austrian Presidential election. Whilst the Austrians unexpectedly rejected the far right Presidential candidate in favour of his EU friendly green party opponent, the Italian Premier fared less well. By polling day, the referendum on constitutional reform had turned into a vote on his leadership. He lost convincingly and immediately announced his resignation.

The balance of probabilities suggests that a technocrat government will be formed to see out the rest of the term; Italian general elections are due by spring 2018. Indeed, even if the anti-establishment 5 Star party wins at the next general election (a big "if"), a subsequent EU referendum (favoured by Grillo, the 5 Star leader) would not necessarily lead to Italy's EU departure. In a recent poll, 67% of the Italian population described themselves as single currency believers. No matter, the departure of Renzi heralds a period of policy paralysis which, in turn, leaves the insolvency of the Italian banking system front and centre. With EU sanctioned bail outs unlikely, the banks will limp on, propped up by ECB monetary policy. Drowning in bad debts, defensive local banks will further handicap weak Italian growth. This makes an upset at the next election increasingly likely as the electorate wrestles with elevated unemployment and shrinking real wages.

Meanwhile in France, the Eurostoxx index fell 0.7% last month as Francois Fillon won the Republican presidential primary on a Thatcherite ticket of aggressive reform. He is currently favourite to triumph over the Socialist party and Marine Le Pen of the National Front in the March/April general election; any sign that he looks vulnerable will raise the risk premium on EU assets. In economic news, whilst Eurozone headline unemployment finally dipped beneath 10%, to 9.8%, the picture varies considerably across member states. German unemployment, at 4.1%, stands in stark contrast to Greece (23%), Spain (19%) and Italy (12%) (source: Eurostat). The distance between core and peripheral EU nations remains obvious.

In emerging markets, the pervasive sense that Trump trade policy will harm global exporters left markets generally weaker; the MSCI emerging market index fell 4% for the month. Mexico was the most obvious loser, as it remains the focus of the Trump protectionist trade tirade. Its stock market fell by 6% during the month, whilst Brazil was also down 5%. The effect was exacerbated by weaker currencies. The Mexican peso lost 8% against the US dollar whilst the real fell 6%. Elsewhere in emerging markets, China announced that the Shenzhen Connect, which links Shenzhen and Hong Kong stock markets, will open on 5th December. The facility will give global investors access to the Shenzhen market via Hong Kong (and vice versa).

BONDS

US bond prices fell and yields rose in reaction to the election. Yields on 10-year treasuries have risen by over 1% since the July low of 1.4%, whilst the Bloomberg Barclays US Treasury index lost 3% this month. Inflation expectations in the US are now running above the Federal Reserve's 2% target rate. Following the election, Chair Janet Yellen said that the Fed would likely raise rates by 0.25% at their 14th December meeting. She also reiterated her plan to see out her term which expires in 2018 despite fierce criticism from Donald Trump on the campaign trail. In economic news, US data has been relatively robust of late. Q3 GDP was revised up to 3.2% from 2.9% in the latest estimate. The majority of the change was due to stronger consumption growth, although investment remains weak. The latter is approaching recessionary levels, leaving the consumer as a key economic driver. In this regard, real wage growth bears close attention.

UK Government bonds also fell in value over the month. The FT All Stock Gilt index lost 1% in November as the yield on 10-year gilts ticked up from 1.2% to 1.4%. We think this has further to go as sterling's depreciation filters through to domestic prices. Early evidence of this includes the 10-20% increase in Apple product prices and the return of 1970s 'shrinkflation' (less product, in the same packet, for the same price). Anecdotes aside, cost push inflation will become apparent as we get past normal Christmas discounting. We retain very limited exposure to nominal fixed income across all mandates. Chancellor Philip Hammond's first and last autumn statement contained very few surprises. As widely trailed, he relaxed his predecessor's fiscal rules. Rather than targeting a budget surplus in 2019-20, Mr Hammond said he would look to run a balanced budget as soon as possible in the next parliament. He also committed to borrowing up to £23bn over 5 years to invest in infrastructure and innovation.

In Europe, investor nerves ahead of the Italian referendum led to yields blowing out on Italian debt. The spread between 10-year bonds in Germany and Italy, which started the year at less than 1%, increased from 1.5% to 1.7%. German bonds remain the EU haven asset; ten year bunds yield less than 0.3%.

In Asia, the Bank of Japan stepped back from its inflation target of 2%. Governor Kuroda said that monetary policy alone was insufficient, and that stimulus measures must be backed by fiscal policy and structural reform. Our belief that the Bank of Japan is reaching the limit of its effective monetary policy tools continues to grow. Over in Australia the RBA kept interest rates at 1.5% as headline consumer price inflation remained muted at 1.3%. With Australian inflation looking well anchored, the recent sell off in local debt is increasingly interesting; the 10-year government bond now yields nearly 2.8%.

CURRENCIES

With US rates set to rise, the trade weighted dollar rallied 3% last month. It is now within 2% of its February 2002 all-time high. The broad based strength in the dollar meant that most other major currencies were weak, with the exception of sterling and the Swiss franc. They both appreciated by over 2%, whilst the Japanese yen tumbled 9% to ¥114 and the Euro lost 4%. Talk of the single currency trading at parity to the dollar is growing in both volume and credibility.

As mentioned above, emerging market currencies also came under pressure, with the Mexican peso and Brazilian real falling by 8% and 6% respectively. Perhaps more importantly, the Chinese yuan continued to slide as the People's Bank of China (PBoC) lowered its yuan dollar reference rate for 12 days in a row. It fell by 2% to an eight-year low of RMB6.9. Trump's promise to label China a currency manipulator on day one in office has prompted fears of a trade war and a reacceleration of capital outflows. The latter has been amplified by signs of rising local inflation and growth that remains dominated by heavily indebted "old China". To stem egregious capital flight, the government is clamping down on large overseas M&A transactions; many recent deals have been a form of disguised capital flight. Furthermore, to control growing signs of asset bubbles and unproductive lending, the PBoC cut back on seven day open-market operations, providing liquidity to the economy through more 14 and 28 day contracts. Taken together, this makes short term funds scarcer, generating a steeper yield curve and wider credit spreads. Though President Xi remains committed to an orderly economic reality in the run up to the autumn national congress, Chinese growth remains a fragile construct with obvious challenges.

In India, Prime Minister Narendra Modi announced a shock crackdown on the cash-dominated, black economy. He declared that 500 and 1,000 rupee notes would no longer be legal tender. This move affected 86% of cash in circulation, worth around $215bn. The old notes can be swapped for new 500 and 2,000 ones up until year end. Limitations have been placed on cash withdrawals at banks and ATMs in the mean time. The move follows on from the three month amnesty on undeclared wealth which harvested 65bn rupees (U$1bn). The black economy is estimated to constitute anywhere between 20-50% of Indian GDP. Though Modi quite reasonably hopes that the move will lead to a decline in corruption and a rise in government tax receipts, the short term impact is a sharp contraction in economic activity. The rupee fell by 3% last month.

GOLD/COMMODITIES

Oil prices rocketed 8% on the final day of the month after the OPEC cartel reached a new production agreement. WTI finished the month up 4%, just shy of $50 per barrel. Brent rose 5% to $52. OPEC agreed to reduce production to 32.5m barrels per day (bpd) from the current level of 34.0m. The bulk of the cut will be borne by Saudi Arabia who will trim production by 486,000 bpd. It is envisaged that non-OPEC members will reduce production by 600,000, with Russia accounting for half of that. The deal smacks of economic desperation by OPEC members; they started a price war which they cannot, now, afford. Their implied intent of destroying US shale producers has come up short; indeed, higher crude prices will simply encourage a pick-up of increasingly efficient shale activity. This must surely cap oil prices if one looks out 12-18 months.

A strong US dollar and rising treasury yields has proved bad for gold. Bullion fell by $104 to $1,173/oz in November; an 8% loss. Market expectations that 2017 heralds 2-3 more US rate rises, means that gold is likely to remain under pressure in the short term. However, unless US real growth improves markedly (which we doubt), gold remains a decent hedge against further debasement of fiat currencies, should Central Banks once more be called into action. It also retains its haven status as we continue to confront heightened political instability.

In contrast to precious metals, base metals rebounded strongly, led by copper which gained 20% last month. Good US housing data and expectations of new infrastructure investment saw the metal move significantly higher. Prices were also helped by recent PMI data in China, evidencing solid manufacturing activity. The official PMI rose to 51.7 from 51.2, the highest level since July 2014.

Most agricultural prices were down last month as a result of the strength in the US dollar. Coffee and cocoa were both off 10%. The Ivory Coast recently established tax breaks on the export of both crops which has boosted production. Although there was a global cocoa deficit last season, good weather has meant this imbalance has been smaller than expected. The International Cocoa Organization (ICCO) cut estimates of the 2015-16 shortage by 29% to 150,000 tons.

POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

6-12 MONTH VIEW	EQUITIES	BONDS	ALTERNATIVES
+	LATIN AMERICA	INFLATION LINKED	UNCORRELATED STRATEGIES, GOLD
O	UK, AUSTRALIAN, ASIA, RESOURCES, HIGH YIELD, TECHNOLOGY, HEALTHCARE	AUSTRALIAN	
−	US, EUROPEAN, JAPANESE	US, UK, EUROPEAN, JAPANESE, CORPORATE, HIGH YIELD	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	30-NOV-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2506	+2.2%	-4.8%	-16.9%
CHF	0.9829	-2.8%	-3.3%	+1.1%
AUD	0.7385	-2.9%	-1.8%	+2.2%
JPY	114.46	-8.4%	-9.6%	+7.5%
EUR	1.0589	-3.6%	-5.1%	+0.2%
BOND YIELDS (10 yr)				
UK	1.42	+0.17	+0.77	-0.41
US	2.38	+0.56	+0.80	+0.18
Germany	0.27	+0.11	+0.34	-0.20
Australia	2.72	+0.38	+0.90	-0.14
Japan	+0.02	+0.07	+0.09	-0.28
EQUITIES				
US. S&P 500 (USD)	2,198.81	+3.4%	+1.3%	+5.7%
UK. FTSE 100 (GBP)	6,783.79	-2.5%	+0.0%	+6.7%
MSCI Europe ex UK (EUR)	1,142.73	-0.2%	-0.4%	-10.3%
Japan. Topix (JPY)	1,469.43	+5.5%	+10.5%	-7.0%
China. Shanghai Comp (RMB)	3,250.04	+4.8%	+5.3%	-5.7%
HK. Hang Seng (HKD)	22,789.77	-0.6%	-0.8%	+3.6%
Australia. All Ords (AUD)	5,502.38	+1.8%	-0.5%	+5.4%
MSCI Pacific ex Japan (USD)	1,180.85	-0.6%	-0.5%	+6.5%
MSCI World (USD)	1,712.09	+1.3%	-0.4%	+1.0%
MSCI World (GBP)	1,369.89	-0.9%	+4.7%	+21.6%
COMMODITIES				
Oil (WTI)	49.44	+4.2%	+6.3%	+1.3%
Gold	1,173.25	-8.1%	-10.4%	+10.2%

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