BENTLEY REID

INVESTMENT VIEWS

MARCH 2016

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EQUITIES	:	A sharp bounce fails to recoup 2016 losses
BONDS	:	Negative base rates push yields lower
CURRENCIES	:	Brexit hits sterling as the Yen defies the BoJ
COMMODITIES	:	Gold & iron ore push higher as oil drifts

Despite a troubled start to the year, a solid rally from February lows has left US and UK stock markets 2-3% lower for the year to date. Admittedly, European, Japanese and Asia markets have fared worse but the air of panic seems to be dissipating. No cause for alarm then?

Sadly we fear not. With global equity markets entering bear market territory earlier this year (defined as a 20%+ peak to trough fall), the sheer pace of the sell-off since August suggested a bounce was possible. Cue some slightly better US economic figures in February and the subsequent market recovery was amplified by bearish investors being squeezed out of their positions. Though welcome, having weathered the New Year storms, we have used this rally to increase portfolio protection. Why? The core issue of record debt levels remains. ECR Research estimates that total global debt rose by \$60 trillion to \$200 trillion between 2007 and 2014; equivalent to 257% of GDP. As we have commented before, much of the incremental debt has been used to build unproductive capacity that will never generate a sustainable economic return. Furthermore, political imperatives and rock bottom interest rates have preserved this wasteful excess, feeding the deflationary winds that sweep the economic landscape. The sell-off did nothing to address this.

Figures since the start of the year suggest things are getting worse, not better. Chinese economic metrics continue to soften, with forward looking manufacturing surveys remaining weak despite another year of supportive fiscal and monetary steps. As a Bloomberg article notes, nominal 4th quarter GDP in US dollar terms added 4.25%, or \$439bn, compared to a year earlier; this contrasts to 13% growth two years earlier, equivalent to \$1.1bn. The decline in nominal GDP growth (not inflation adjusted) makes debt servicing more difficult, as corporate cash flows shrink; a fact acknowledged by Moody's when they lowered their outlook for China's credit rating in early March. It also helps explain shrinking trade, as both export and import volumes contract. The latter is of note to Asian equity markets, given their historically tight correlation to Chinese imports.

In Europe, regardless of whether a June "Brexit" questions the integrity of the fragile Union, recent manufacturing and service sector (PMI) surveys point to slower growth. This is a concern as the region is currently expanding at about 1% pa, with deflation reappearing in February. Likewise, inflation remains absent in Japan, with the economy shrinking at an annualised rate of 1.4% as 2015 closed. With wage growth wanting and a firmer Yen challenging exports, a self-sustaining reflationary period remains a way off. After such a poor return on such aggressive stimulus, the social and structural challenges to the "3rd arrow" of Abenomics (productivity producing structural reform) have cooled our Japan ardour.

The one potential bright spot is the US where early year activity has picked up from a surprisingly weak fourth quarter. Job creation and wage growth remain solid, with decent housing activity providing further comfort. Though the pace of the US expansion is slowing (the IMF has trimmed its 2016 estimate by 0.2% to 2.6%) a sharp recession this year seems unlikely. The problem is that if this improvement is sustained, markets will probably price in US rate rises, driving the US dollar higher, and thereby aggravate the challenge for non-US entities with dollar liabilities. Furthermore the stronger dollar will act as a headwind for US activity, making it increasingly vulnerable to the unfolding global slowdown.

Turning to markets, despite their decline, valuations are not compelling. Fourth quarter profits for the US S&P 500 index shrank 3.5%, marking nine months of profit contraction; revenues declined by a similar amount. Furthermore, first quarter profit growth is now expected to fall by 5.7%; a 2.3% expansion was projected at the start of the year (source: Thompson Reuters). In the US and further afield, earnings have generally followed the markets lower, leaving equities as or more expensive than before the index falls.

Central Banks are alive to this reality, though the February G20 meeting failed to elicit a co-ordinated international response. There was vague talk that Governments should "use fiscal flexibility to bolster growth", but nothing concrete. Investors are now questioning the power of individual Central Banks, with markets reacting negatively to the latest QE efforts of both the European Central Bank (ECB) and the Bank of Japan (BoJ).

No matter, we suspect the ECB and the BoJ will cut base rates further into negative territory, with others following suit. To us, this would be an error. With nearly 30% of developed nation sovereign debt yielding less than 0% (and another third yielding 0-1% pa), it is not the supply or price of money that is the issue. Negative rates will simply scare people into a deflationary mindset, encouraging them to save more due to a nil return on cash and lower expectations of future wealth. Furthermore, it undermines bank profitability, impacting their willingness and ability to lend.

Negative interest rates will simply hasten a denouement that will finally convince global authorities to act in unison, with politicians realising that a productive fiscal expansion must complement exhausted monetary policy. Inflation will surely colour this outcome. The path to such an accord will probably lead markets lower. We thus feel comfortable reinforcing portfolio defences whilst researching the growing number of opportunities borne of increasingly irrational markets.

IN OTHER NEWS…

As we noted before the UK general election last year, gambling odds, backed by real money, tend to be better guides than the official polls.

In the US, after the Super Tuesday primary elections, Hilary Clinton is now priced at 1.04 (bet £1 to win £0.04) to be the democratic nominee. Her likely adversary will be Donald Trump, currently priced at 1.29 to win the Republican nomination; his nearest rival, Marco Rubio, is at 7.0. As regards the November 8th Presidential election, Clinton is the hot favourite at 1.57, with Trump lagging at 4.0.

In the UK, the Brexit debate was enlivened by Boris Johnson declaring for the OUT campaign. This cut the odds of the UK voting to leave from 3.54 to 3.25. This still leaves the campaign to remain IN as the firm favourite at 1.43. On balance, we suspect the bookies are right, though we expect the outcome to be much closer than the odds suggest.

Finally, after the dominance of the cashed up super clubs, it is nice to see Leicester City installed as favourites to win the Premier League; you can still get 2.9 in case you fancy a flutter though a few prescient punters backed them at 1000.0 early in the season.

EQUITIES

Following a difficult January, equities remained volatile in February. Japanese and European markets posted large losses whilst the core markets of the US and UK proved more resilient.

Economic data in the US has been mixed. On the plus side, the second estimate of US fourth quarter GDP was revised up to 1.0% from 0.7%, driven by an upward revision to the level of inventories. January saw US personal incomes grow by 0.5% whilst US core retail sales rose a healthy 0.6%. However, several of the lead indicators deteriorated further towards the end of the month. Manufacturing remains in a rut and the Chicago manufacturing PMI fell to 47.6 from 55.6 in January; a reading below 50 indicates contraction. More alarming perhaps was the downward revision to the US services PMI from 53.2 to 49.7; the first time this has dipped beneath 50 and the weakest reading since October 2013. The S&P 500 index fell by -0.4% in February, leaving it -5.5% lower for the year to date.

In the UK the FTSE 100 rose by 0.2% in February as many of last year's laggards staged a significant rebound. Indeed the top four performing stocks were all mining related: Anglo American (+73.1%), Glencore (+48.9%), Fresnillo (+38.5%) and Randgold Resources (+30.6%). Although some of the underlying commodities rallied, most notably gold and iron ore, many of the commodity industries remain blighted by oversupply. Until we see production capacity reduction, such companies are likely to remain volatile with risks skewed to the downside. In corporate news, decent results from UK housebuilders underpinned a 0.7% rise in the mid-cap FTSE 250 whilst HSBC's board decided unanimously to keep the bank's headquarters in the UK.

The Japanese stock market was one of the worst performing in February. The Nikkei index fell by -8.5% as the BoJ's decision to introduce negative interest rates on 29th January led to a rout in local bank shares. We reduced our allocation to Japanese equities following the negative market reaction to the BoJ decision. Globally, bank shares have underperformed this year on growth concerns and the damaging penchant for central banks to deploy negative rates. Absent a global recession, many banks now trade at compelling valuations; US ones seem to offer the best opportunity due to robust balance sheets and the promise of higher dividends.

European markets also fell back with the Eurostoxx 50 index losing -3.3% during the month. The core markets of Germany (-3.1%) and France (-1.4%) proved more defensive, whilst peripheral markets were harder hit; the Italian market fell -5.5% as Italian banks struggled with rising bad debt provisions. Non-performing loans are estimated to have reached $216bn; approximately 17% of Italian GDP. This could well be a source of market anxiety as the year unfolds.

Generally, M&A activity recovered from a slow start to the year with Swiss chemical firm Syngenta accepting a $43bn takeover offer from China National Chemical. It is set to be the largest foreign acquisition by a Chinese company.

BONDS

The spectre of deflation looms large, encouraging central banks to experiment with negative short term rates. After the BoJ's decision to introduce negative rates at the end of January, bond yields nosedived. The yield on a 10 year Japanese government bond finally fell below zero on 9th February and finished the month trading at -0.06%. During February Japan became the first G7 nation to auction a 10 year government bond at a negative yield. They sold $21bn of paper at a yield of -0.015%. We live in unusual times when investors will pay a heavily indebted Government to lend it funds.

Economic data out of Europe continues to deteriorate. February saw the Eurozone slip back into deflation, with general price levels falling 0.2% after a 0.3% rise in January. The governor of the Bank of France reacted by saying that deflation poses the greatest risk to the Eurozone and that the ECB should be ready to increase stimulus. Einstein's widely attributed definition of madness is doing the same thing over and over again and expecting a different result. We question whether the torrent of cheap money may be the cause of lower productivity and anaemic growth, rather than the solution. Though peripheral debt retreated modestly, core 10 year German bunds rallied over the month. Benefitting from the deflationary worries, they ended on a yield of 0.11%.

In the US, Janet Yellen, head of the Federal Reserve, rowed back from the Fed's "dot plot" matrix that forecast four interest rate rises this year. She told the House Financial Services Committee that economic conditions are evolving and only warranted gradual increases. The futures market promptly priced in the likelihood of only one further rise this year. Economic data remains unimpressive with many lead economic indicators continuing to decline. Until recently the US service industry has been driving economic growth in the face of a manufacturing recession. As we note in the Equity section, the US services PMI came in at 49.7 in February, down from 53.2 in January and much lower than market expectations. In response to weaker data, yields at the long end of the curve tightened. The 10 year yield rallied to 1.73% from 1.92%, whilst the 5yr yield went from 1.33% to 1.21%.

Back in the UK, faced with similar growth concerns, the yield on the 10 year gilt fell from 1.56% to 1.34%. In response, Bank of England Governor Mark Carney ruled out negative interest rates but said he would consider zero interest rates and further QE asset purchases. We find his prognostications unhelpful and inconsistent but guess he is sincere in his stated desire to eschew negative base rates.

In Emerging Markets it was no surprise to see further downgrades for Brazil as economic and political news continued to disappoint. Standard & Poor's lowered its rating from BB+ to BB, ranking Brazil alongside Bolivia, Guatemala and Paraguay. After a period of chronic currency weakness and rising local yields, domestic Real bonds are starting to look interesting for brave investors. There was more encouraging news out of Argentina where the government provisionally agreed to pay $4.6bn to four hedge funds that owned delinquent bonds dating back to its 2001 default. Subject to approval from congress, this should enable Argentina to issue $15bn of new debt to international investors to fund government spending and boost reserves. Elsewhere, China took another small step on the path to more open capital markets when the PBoC eased limits on foreign investments in the bond market. Most types of foreign institution no longer need a quota to invest in the interbank bond market where most of the country's debt resides.

CURRENCIES

Brexit moved front and centre in the UK political debate as Mr Cameron announced 23rd June as the date for the referendum. Boris Johnson announced his support for the 'OUT' campaign prompting sterling to fall 2%, the largest decline in a single day since October 2009. Mr Johnson's backing gave the campaign a significant boost and added some much needed charisma to their leadership. Bookmakers slashed the odds on the likelihood of a Brexit, although the 'IN' campaign remains clear favourite for now. Sterling was one of the worst performing currencies last month. It fell by 2.3% against the US Dollar to $1.39, flirting with a 30 year low. We have for some time retained a dollar bias in many portfolios, although the attraction is less clear following recent moves.

The Japanese Yen was the strongest performing major currency in February. It rose by 7.5% against the dollar from Y121 to Y112.7. Perversely, the main driver of this large move was the BoJ's decision to implement negative rates. The currency did not weaken on the news, as the BoJ intended. For the first time, monetary policy failed to have the desired impact, suggesting that investors are now questioning the omnipotence of individual central banks. As such, although valuations remain cheap (extremely so in some sectors) we reduced our Japanese allocations. There is also no sign of economic activity picking up as household spending fell 3.1%, the fifth month of contraction. Although unemployment remains low (3.2%), there has been no sign of wage growth, a vital part of any self-sustaining recovery.

The trade weighted US Dollar fell by -1.4% in February, partially due to the firm Yen which is the second largest component of the basket (behind the Euro). Although fourth quarter US GDP growth was revised up to 1%, the modest expansion speaks to a slow, drawn-out economic muddle through, with considerable risks to the downside. For now, the windfall from lower energy prices has been saved, rather than underpinning a pick-up in economic activity. From July 2014 to end November 2015 US consumers saved about $122bn due to lower energy prices; this was almost exactly offset by a $120bn rise in household savings (Source: Odey). Unemployment remains low (4.9%) and wage growth has picked up (+2.4% pa), but this has not translated into higher activity as yet. Though the weaker tone to the dollar will be welcomed by many countries (as it reduces downward pressure on their currencies), we still feel that, on balance, the dollar will remain firm.

Turning east, the Caixin China manufacturing PMI deteriorated further from 48.4 to 48.0. The Chinese slowdown has triggered some remarkably bad export data from its main trading partners: Korean exports to China fell 21.6% year on year in January. Having cut base rates 5 times since January 2015, the People's Bank of China (PBoC) lowered the bank reserve requirement ratio by 0.5% during February. Despite this, the Yuan appreciated by 0.3% versus the US Dollar this month, but remains down -4.4% over the past 12 months. Capital flight from the mainland remains a worry as Chinese foreign exchange reserves fell by nearly $100bn in January to $3.2 trillion. If this continues, depreciation pressure will build on the Yuan.

GOLD/COMMODITIES

Oil had a quieter month in February. US WTI fell by $1 to $34, whilst European Brent prices stayed at $37. US oil output has started to fall at the margin. Total US production has declined from 9.21m barrels per day (bpd) at the start of the year to 9.08m. The current production level is now 0.5m bpd day less than the recent peak of 9.6m in June 2015. Although US production data is slowly reacting to lower prices, there is no sign of OPEC cutting production quotas. Saudi Arabia continues to defend its market share, accepting low prices in an effort to bankrupt high cost, competitive production. Despite increasingly desperate noises from troubled producers such as Russia, Nigeria and Venezuela we see no respite in the short term with inventories remaining a significant overhang for the market. Oil stocks at Cushing, Oklahoma hit a 10 year high of 66m barrels, up 13m since October 2015 alone. Continued pain in the oil sector saw oil services firm Halliburton announce plans to eliminate 5,000 jobs, or 8% of its workforce. Natural gas prices also continued their extended slump, down 26% this month to $1.71. Gas prices have now fallen 85% from their 2008 peak.

February saw the price of Gold rally $120 to $1,238. The 11% gain provided a welcomed fillip for our multi-asset portfolios, particularly so in sterling portfolios where the weak pound amplified returns. Year to date gold has gained 16.7% in USD and 23.6% in sterling terms. Retail investors flooded back to the ETF market, adding 5m troy ounces to Gold ETFs during the month; an increase of roughly 10%. Whilst negative interest rates reduce the relative cost of owning gold versus cash deposits, we think physical gold remains a valuable hedge against aggressive reflationary policies and the accelerating debasement of many fiat currencies.

Finally, iron ore prices have rebounded in 2016. The shutdown of the Samarco mine in Brazil, following a dam collapse in November which killed 19 people, has removed 30m tonnes from the market and led to a spike in the spot price. Despite Glencore CEO Ivan Glasenberg's confident assertion that raw material prices have bottomed, the issue of over-capacity remains. As such, the long end of the commodities curve suggests prices will fall back to lower levels. Indeed extra supply from the Roy Hill mine in Australia will hit the market after the summer as will increased production from Vale in Brazil. The price of iron ore rose from $41 per metric tonne to $49 over the month. We remain unconvinced.

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
+		INFLATION LINKED	UNCORRELATED STRATEGIES, GOLD
O	UK, EUROPEAN, JAPANESE, AUSTRALIAN, DEVELOPING, RESOURCES, HIGH YIELD, TECHNOLOGY, HEALTHCARE	AUSTRALIAN	

—	US	US,UK, EUROPEAN, JAPANESE, CORPORATE, HIGH YIELD	

MARKET PERFORMANCE

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

	29-FEB-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3917	-2.3%	-7.6%	-9.9%
CHF	1.0015	+2.5%	+3.0%	-4.5%
AUD	0.7141	+0.8%	-1.2%	-8.5%
JPY	112.69	+7.5%	+9.2%	+6.1%
EUR	1.0873	+0.4%	+2.9%	-2.9%
BOND YIELDS (10 yr)				
UK	1.34	-0.22	-0.49	-0.46
US	1.74	-0.19	-0.47	-0.26
Germany	0.11	-0.22	-0.37	-0.22
Australia	2.40	-0.24	-0.46	-0.06
Japan	-0.07	-0.16	-0.37	-0.39
EQUITIES				
US. S&P 500 (USD)	1,923.23	-0.4%	-7.1%	-8.2%
UK. FTSE 100 (GBP)	6,097.09	+0.2%	-4.1%	-12.2%
MSCI Europe ex UK (EUR)	1,103.65	-3.2%	-13.3%	-13.9%
Japan. Topix (JPY)	1,297.85	-9.4%	-17.9%	-14.8%
China. Shanghai Comp (RMB)	2,687.98	-1.8%	-22.0%	-18.8%
HK. Hang Seng (HKD)	19,111.93	-2.9%	-13.1%	-23.0%
Australia. All Ords (AUD)	4,947.90	-2.1%	-5.2%	-16.1%
MSCI Pacific ex Japan (USD)	1,025.16	-0.7%	-7.6%	-23.5%
MSCI World (USD)	1,547.17	-1.0%	-8.7%	-12.7%
MSCI World (GBP)	1,112.04	+1.2%	-1.3%	-3.2%
COMMODITIES				
Oil (WTI)	33.75	-4.3%	-24.6%	-45.5%
Gold	1,238.74	+10.8%	+16.3%	+2.1%

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