BENTLEY REID

# INVESTMENT VIEWS

## APRIL 2016

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| **EQUITIES** | : | Cyclicals and emerging markets lead the recovery |
| **BONDS** | : | "Safe Haven" bond yields head towards historic lows |
| **CURRENCIES** | : | A dovish US Fed prompts pervasive dollar weakness |
| **COMMODITIES** | : | Global reflation efforts push oil and metals higher |

In a recent meeting, whilst acknowledging our fixation on all things China, a client asked why we have so little US equity exposure. The lady in question correctly noted that we have our lowest ever exposure to US stocks. Given that the American stock market accounts for nearly 60% of the MSCI world equity index by value, our reasoning bears repeating.

First and foremost, valuation is elevated. On a simple trailing earnings basis, the S&P500 index trades at about 19 times 2015 earnings. This is well north of the long term average of 15 times. However it is not this (overly) simplistic valuation metric that frays our nerves. It is the prospects for revenues and leveraged balance sheets that make us uneasy.

In 2015 US companies executed share buybacks worth U$569bn; about 3% of the total market value. This is obviously a key market support, especially when one considers that the US stock market only produced a total return of 1.4% last year.

Is such spending sustainable? We doubt it. According to Factset, the sums spent are equivalent to 102% of the free cash flow after dividends (FCFAD) produced by US companies last year; that is up from 82% at the end of 2014. In other words, having paid dividends, companies spent more on their own stock than they produced in free cash flow. Furthermore, though the energy sector is a major trouble spot, the general theme is pervasive; the industrial sector, for example, spent 86% of FCFAD on buybacks. As the first quarter is expected to show US corporate revenues declining for their fifth consecutive quarter, buybacks or dividends (or both) must surely be at risk.

This parlous state also threatens increasingly leveraged balance sheets. With Central Bank QE supressing the cost of capital, companies have been able to borrow cheaply without the discipline of a market driven interest rate. The value of US corporate debt (ex-financials) has doubled from pre-crisis levels, sustained by a drop in the average interest rate paid from 6% in 2009 to a little over 4% in 2015 (*source: Goldman Sachs*). Balance sheets and profitability are now very interest rate sensitive. This might not be an issue if the funds had been used for investment that increased future productive capacity. Unfortunately, most of the proceeds are being used to fund questionable M&A, dividends and those fragile share buybacks. As regards the latter, one third of S&P500 companies spent more on buybacks than they earned in 2015; a trend that is set to continue as the first quarter heralds a year of shrinking US corporate profits. It is thus no surprise to see a 2.8% contraction in US durable goods orders in March (a decent proxy for corporate investment), continuing a steady decline since mid 2014. The fall-off in US productivity growth is surely anchored in this reality.

Taken together, corporate America appears vulnerable. With that in mind, it is troubling to see US retail sales growth softening, suggesting that the all important US consumer may not ride to the rescue. Despite oil prices more than halving from mid 2014 to the end of 2015, consumers have chosen to save rather than spend; US savings as a percent of disposable income rose from 4.8% to 5.4% over the same period. This is not that surprising. The large demographic cohort of retiring baby boomers are looking at their savings and panicking. World stock markets are where they were a decade ago and cash deposits offer a negligible yield. Rather than stimulating spending, the current vogue for zero or negative interest rates in forcing people to save more to offset low returns on retirement savings.

On this last point the message seems clear. QE and low rates helped stop a disorderly break up of the global financial system during the 2008-09 crisis. However their enduring, global nature and the worrisome embrace of negative interest rates are now doing harm. It is forcing consumers to save more, to offset low returns, and it is allowing companies to leverage up their balance sheets to pursue unproductive, short term goals; both depress economic activity. In our view, the US Federal Reserve should continue its gradual move to interest rate normalisation. We do not believe, for one moment, that higher US rates will be a pain free exercise; far from it. A firmer dollar would be all but inevitable, reigniting the broad spectrum of early 2016 market concerns. However unpalatable this may seem, if the current low rate environment persists, the eventual denouement will be far, far harder.

Though not alone, the US equity market is a perfect expression of these concerns and, unlike China, the data transparency makes it easier to arrive at a clear conclusion.

## IN OTHER NEWS…

On the 31st March, the veteran comic actor Ronnie Corbett passed away. He was 85. He initially found fame in "The Frost Report" (1966), acting alongside John Cleese and other members of the (yet to be formed) Monty Python crew. He also met Ronnie Barker on the show; they went on to form "The Two Ronnies" which ran for 16 years on the BBC, ending in 1987. A keen golfer and cricket fan, he also kept bees at his East Lothian holiday home. One of his gags to follow….

"A man was marooned on a desert island. One day a beautiful woman arrives in a wet suit. 'When did you last have a smoke?' she asks. 'Five years ago.' So she gets out a cigar and he smokes it. She unzips her wet suit a bit and says, 'When did you last have a drink?' He said, 'Five years ago.' So she gets out a bottle of Scotch and he has a drink. Then she unzips her wet suit a bit more and says, 'And when was the last time you played around?' He looks at her in amazement and says: 'You're not telling me you've got a set of golf clubs in there?'"

## EQUITIES

The rebound from the February stock market lows gathered pace last month, bringing a turbulent quarter to a close. Despite a 7% monthly advance for the MSCI World index, it finished the quarter with a 1% loss in dollar terms.

Emerging market stocks and the more economically-sensitive names led the pack, posting double-digit gains over the month. This partly reflects depressed valuations. Underperformance has been so pronounced in recent years that a lot of "bad news" is arguably in the price. It also speaks to aggressive short-covering by bearish speculators who have rushed to close positions that would have profited from further market falls. Technical indicators suggest the bulk of this covering is now complete.

The "relief rally" has unfolded despite a broad based deterioration in fundamental news. Manufacturing sectors are still contracting and recent data points speak to flagging consumer demand. It is becoming increasingly evident that households are choosing to save rather than spend the windfall from lower energy costs, which in turn places an even greater onus on governments and Central Banks to stimulate activity.

So why then, with economic and corporate profits growth on the wane, are developed market indices heading back towards their all-time highs? The answer, once again, is cheap money. Last month saw a raft of dovish announcements from monetary authorities with the European Central Bank, cutting interest rates to -0.4% in a bid to counter mounting deflationary pressures. Eurozone CPI was -0.1% pa in March, the second consecutive month of falling prices.

A more significant development came from the Federal Reserve with Chairwoman Yellen backtracking on the Committee's earlier forecast of four interest rate rises in 2016. Faced with a much weaker than expected fourth quarter US GDP print of 0.7% pa, she used a speech at the Economic Club of New York to reiterate the need to "proceed cautiously" in tightening monetary policy given unfavourable market conditions, weaker overseas growth and an uncertain outlook.

Her words buttressed concerns that US and global growth is not strong enough to withstand higher borrowing costs and a stronger dollar. The money markets are now pricing in two rate hikes this year but, with November's Presidential vote fast approaching, it could be less. The Fed typically refrains from acting in the six months before an election. The US dollar bore the brunt of Yellen's dovish remarks, falling by 4% on a trade-weighted basis in March.

The greenback's weakness helps explain the more "risk on" timbre of March markets. It improves the outlook for US GDP, making exports more competitive, and reduces the funding cost for non US dollar borrowers; a major area of concern given the post crisis build-up of overseas dollar liabilities. As 2015 drew to a close, we argued that risk assets would have a close correlation to the US dollar this year; further appreciation would generally spell bad news for equity markets, whereas a sell-off could drive share prices higher. So far this relationship has held true.

Most developing nations have benefited handsomely from the dollar's pullback; the MSCI Emerging Markets index rose by 8% last month. A continued rebound in commodity prices also helped boost sentiment. Indeed, two resource-focused markets were the lead performers in March with the Brazil and Russia bourses gaining 17% and 14%, respectively.

Brazil is facing some of its worst ever economic conditions; output contracted 4% last year, with a similar outcome slated for 2016. However, an 80% collapse in the US dollar value of the Brazilian stock market since 2011 suggests these travails are well known. Indeed, as the "Lava Jato" corruption scandal ensnares members of the business and ruling elite, we have been encouraged by political developments. President Rouseff's botched attempt to give her predecessor, Lula, a ministerial job to shield him from federal prosecution raises the odds on her impeachment; this would be a welcome first step on the road to change and economic stability. That said, with social unrest set to mar the forthcoming Brazil summer Olympics, troubled news flow may distract from any political and economic progress.

Despite a second month of solid gains for the mining and energy stocks, the resource heavy FTSE 100 index lagged in March, rising by 1%. All UK indices underperformed as "Brexit" fears weighed on sentiment; financials and home builders have suffered heavy losses this year as both sectors are seen as losers if the UK leaves the EU.

US stocks enjoyed a healthier month with the S&P 500 index rebounding 7%, erasing year-to-date losses. The January pull back and the weaker dollar created buying support for the dominant tech listings such as Alphabet (previously Google), Amazon and Facebook. The tech sector now represents over 20% of the index and derives a significant portion of its sales from overseas. Accordingly, profits expectations tend to have a positive correlation to a softer dollar.

Otherwise there remains a negative tone to US corporate news. As per the lead article, S&P 500 firms are experiencing a profits recession, born of lower revenues and (with wage increases becoming more prevalent) higher costs. If the first quarter profit recession is confirmed, it will mark a year of declining profits; a trend not seen since the 2008-09 financial crisis. With the earnings backdrop set to remain weak as we head into summer, US equities are increasingly expensive on both a trailing and prospective profit basis.

## BONDS

Despite a pause last month, the first quarter was a strong one for core Government bonds. January and early February saw yields tumble/prices rise as a "safe haven" bid prevailed. Dovish Central Bank actions subsequently helped sustain demand despite a recovery in risk appetite during March.

This meant most developed nation sovereign 10-year paper finished the month at or near record low yields; US Treasuries offered 1.8% p.a. with the UK equivalent yielding just 1.4%. These compare favourably to Japan, where the 10-year JGB yields -0.04%, and Europe, where longer-dated yields are approaching negative territory; the 10-year German Bund now offers 0.2% p.a. Bloomberg estimates that 30% of the government bond universe is now trading at negative yields; strange times indeed.

The past month has seen a notable outperformance of index-linked bonds, whose coupons are linked to the rate of inflation. Though global pricing pressures remain subdued, negative rates have reignited concerns about future inflation whilst consumer price indices have started to nudge higher. This is particularly true of "core" gauges, which strip out the volatile effects of food and energy costs. In the US, core CPI has accelerated to 2.3% pa, from a 2015 low of 1.6%. This has driven demand for US inflation-proof bonds with the TIPS index rising 2% last month. A similar dynamic unfolded in the UK where core CPI has risen to 1.2% from a 2015 low of 0.8%; index-linked gilts added 1% in March.

Though a stabilisation of commodity prices may allay near term fears of US and UK deflation, we expect global deflationary headwinds to persist, born of surplus capacity and pervasive, elevated indebtedness. We sense that this reality will reassert itself as we head towards the autumn, risking an aggressive reflationary response from Central Banks and their political overlords. Ultimately, we still believe that the current uncertainty ends with rising inflation as it is the only politically acceptable way to address unsustainable global debt levels.

In credit markets, after a tough start to the year, they enjoyed the "risk on" rally. Both high quality and junk bond spreads narrowed, recouping earlier year losses. The iShares US$ Investment Grade tracker added 3% last month, whilst the Citigroup High Yield index (local currency) rose 5%. However, both are still loss-making on a twelve month view.

Looking ahead, we welcome the upturn in the default cycle as it suggests that uneconomic debts are starting to be addressed; the US high-yield default rate reached 3% in February, a 6-high year. That said, it remains low compared to previous periods of distress and has so far been dominated by the beleaguered energy sector. The US junk bond spread fell back to 6.5% last month from a January peak above 8%. Given our cautious outlook, low grade bond prices seem insufficient to compensate for the risk of rising default and market illiquidity.

## CURRENCIES

As mentioned above, the recent weakening of the US dollar has had far-reaching consequences. For now we retain our dollar bias, as any further signs of rising US inflation could prompt speculation of accelerated rate rises. That said, we have tempered our upside expectations, given the historic rise in the trade weighted dollar over the last few years.

Despite the greenback's fall, the Chinese renminbi rose by almost 2% last month and 1% over the quarter. Having forsaken the dollar peg last year, the renminbi's value is now informed by a trade-weighted index. Although the dollar forms 26% of index, the euro (21%) and yen (15%) now have a significant influence. Their recent appreciation placed upward pressure on the renminbi.

As regard the Euro and Yen, we are a tad perplexed by their continued strength in the face of determined efforts by the related Central Banks to devalue the currencies. The euro gained 5% last month and although the yen flatlined against the dollar, it finished the first quarter 7% higher. The yen's move is particularly quixotic, given Japan's feeble economy. February industrial production fell 6% month-on-month, the most since the 2011 tsunami, whilst retail sales contracted. The private sector is evidently spooked by a paucity of wage rises and the Bank of Japan's adoption of negative rates. Yet another large fiscal response is underway with a record ¥97trn budget being approved by parliament last month. This adds to the sense that "Abe-nomics" has reached the "all-in" phase.

Sterling defied poor manufacturing data and "Brexit" fears to rally against the dollar in March. It finished 3% higher, at U$1.44, but is down 3% for the year-to-date. It fared less well against other major currencies. Further falls are likely and not just because of mounting political uncertainty. The ballooning current account deficit has now touched £32.2bn or a record 7% of GDP. This prompted Governor Carney to compare the UK to Blanche DuBois, given its reliance on the "kindness of strangers". Put simply, net capital inflows are needed to plug the deficit gap; a hard sell given the looming referendum.

## GOLD/COMMODITIES

Oil prices finished higher last month; the WTI price rose 8% to U$38/barrel whilst Brent added 11%, to U$40. It seems the market is trying to find a bottom even though the supply/demand imbalance persists. Iran continues to ramp up post sanction production; it pumped 3.2 million barrels per day (mbpd) compared to 2.8mbpd in December. Given its stated intent to push production to 4mbpd, Saudi Arabia remain shy of an OPEC production cut despite the protestations of high cost producers like Venezuela and Russia. Elsewhere, US inventories remain elevated despite local production contracting on an annualised basis for the first time since 2011. Given the supply overhang, a prolonged rise in the oil price seems unlikely. That said, any sign that troubled producers are finally cutting loss making capacity could prompt a sharp, but ultimately self-defeating, rally.

Despite easing 0.5% to U$1,232/oz in March, gold has been one of the best performing asset classes this year. It finished the quarter 16% and 19% higher in dollar and sterling terms respectively. Speculative demand is returning as investors seek protection from the intensifying "currency war." The adoption of negative interest rates in Europe and Japan removes one of the long-held constraints on owning bullion; the zero yield on gold is better than a negative one. Central Bank purchases are also rising, collectively amounting to 483 tonnes in 2015. We have recently added to our bullion exposure.

Industrial metals continued their recovery last month encouraged by extra monetary and fiscal support from a number of governments. The authorities in Canada and Japan have recently increased Government spending in an effort to boost demand, whilst European Governments are using refugee outlays as cover for broader fiscal laxity.

Even though last month's National People's Congress sanctioned a rise in the 2016 budget deficit from 2.3% to 3%, Chinese stimulus remains dominated by monetary measures with annual credit growth back up to 15%. Odey Asset Management estimates that it now takes U$6.50 of extra lending to generate U$1 of additional GDP, questioning the sustainability (advisability?) of further debt fuelled endeavours. Regardless, in the near term, the sheer scale of the credit impulse could stimulate industrial and manufacturing activity. This, coupled to the softer dollar, helped push the CRB Raw Industrials index 4% higher last month, taking its quarterly gain to 9%.

## 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 |
|---|---|---|---|
| + | HIGH YIELD | INFLATION LINKED | UNCORRELATED STRATEGIES, GOLD |
| O | UK, EUROPEAN, JAPANESE, AUSTRALIAN, DEVELOPING, RESOURCES, TECHNOLOGY, HEALTHCARE | US, UK, AUSTRALIAN | |
| – | US | EUROPEAN, JAPANESE, CORPORATE, HIGH YIELD | |

## MARKET PERFORMANCE

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

| | 31-MAR-16 | 1 MTH | 3 MTH | 12 MTH |
|---|---|---|---|---|
| **CURRENCIES (VS USD)** | | | | |
| GBP | 1.4360 | +3.2% | −2.6% | −3.1% |
| CHF | 1.0397 | +3.8% | +4.2% | +1.1% |
| AUD | 0.7657 | +7.2% | +5.1% | +0.7% |
| JPY | 112.57 | +0.1% | +6.8% | +6.7% |
| EUR | 1.1380 | +4.7% | +4.8% | +6.0% |
| **BOND YIELDS (10 yr)** | | | | |
| UK | 1.41 | +0.08 | −0.55 | −0.16 |
| US | 1.77 | +0.03 | −0.50 | −0.15 |
| Germany | 0.15 | +0.05 | −0.48 | −0.03 |
| Australia | 2.49 | +0.09 | −0.39 | +0.17 |
| Japan | −0.04 | +0.03 | −0.30 | −0.43 |
| **EQUITIES** | | | | |
| US. S&P 500 (USD) | 2,059.74 | +6.6% | +0.8% | −0.4% |
| UK. FTSE 100 (GBP) | 6,174.90 | +1.3% | −1.1% | −8.8% |
| MSCI Europe ex UK (EUR) | 1,123.39 | +1.8% | −7.5% | −14.4% |
| Japan. Topix (JPY) | 1,347.20 | +3.8% | −12.9% | −12.7% |
| China. Shanghai Comp (RMB) | 3,003.92 | +11.8% | −15.1% | −19.9% |
| HK. Hang Seng (HKD) | 20,776.70 | +8.7% | −5.2% | −16.6% |
| Australia. All Ords (AUD) | 5,151.79 | +4.1% | −3.6% | −12.1% |
| MSCI Pacific ex Japan (USD) | 1,141.13 | +11.3% | +0.8% | −13.3% |
| MSCI World (USD) | 1,648.12 | +6.5% | −0.9% | −5.3% |
| MSCI World (GBP) | 1,145.00 | +3.0% | +1.5% | −2.4% |
| **COMMODITIES** | | | | |
| Oil (WTI) | 38.34 | +7.8% | −4.1% | −33.1% |
| Gold | 1,232.71 | −0.5% | +16.1% | +4.1% |

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29 Queen Anne's Gate, London SW1H 9BU, England,
**Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk**
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