BENTLEY REID

INVESTMENT VIEWS

MAY 2016

www.BentleyReid.com

EQUITIES	:	A weak dollar underpins the rally
BONDS	:	Sovereigns drift as Central Banks pause
CURRENCIES	:	"Abenomics" threatened by Yen surge
COMMODITIES	:	Oil and gold continue to lead

News that the Chinese economy expanded at an annualised rate of 6.7% in the first quarter was greeted with relief. The outcome was better than the doomsayers had predicted and fell neatly in the middle to the 6.5-7% target range set by the Government. What's more, the strength seemed pervasive with March exports, fixed asset investment and retail sales climbing more than 10% over the year.

Unfortunately if one digs deeper, the reality is less rosy. Quarter-on-quarter growth, at 1.1%, was the slowest since 2011 and solid March data simply offset a feeble February. To illustrate the point, impacted by the week long lunar new year holiday, exports fell 25% in February; a firm close to the quarter was thus to be expected. Of more concern the reacceleration from the late 2015 slowdown has been driven by a flood of cheap credit and a surge in government spending; neither is efficient or sustainable. The latter rose 20% during the first quarter, whilst net new borrowing rose at an annualised rate of 50%, the fastest increase on record.

Total Chinese debt (government, companies and households) now stands at 250% of GDP, akin to the US or the EU. Having risen rapidly from around 150% in 2007, the sheer pace of the debt accumulation and the underlying political imperatives guarantees elevated levels of unproductive borrowing and bad debts. Tim Bond at Odey Asset Management estimates that it took more than RMB15 of extra lending to generate RMB1 of GDP in the first quarter, up from RMB2 of lending pre-2008. Furthermore, though local regulators report bank problem loans at about 5.5% of the $1.3 trillion total, the IMF is less sanguine. It estimates that 15.5% of all commercial debt is "potentially at risk", defined as borrowers with insufficient income to cover debt interest payments. If you listen to hedge fund managers like George Soros or Kyle Bass, the truth may be several orders worse.

In an implied acknowledgement of these challenges, Premier Li Keqiang is proposing debt for equity swaps as a means of reducing corporate leverage and lifting non-performing loans off bank balance sheets. Though that may well delay bad debt write downs, even the head of China Construction Bank, the 2nd largest bank in the world, suggested such actions might simply replace "bad debt with bad equity". A nostrum at best?

Slower Chinese GDP growth and absent inflation is exposing the economically vulnerable. The average time it takes local companies to receive payment for their goods and services recently hit 192 days; up from 125 days in 2011. This is stressing corporate cash flows, forcing them to become more reliant on expensive bank debt and triggering corporate insolvency.

After a benign period for the nations $3 trillion credit market, bond defaults are rising rapidly. The net number of Chinese companies downgraded by S&P has hit a 13 year high, pushing yields and spreads on lower quality debt higher. Though these moves are from historic lows, the sell off is gaining pace just as 2016 refinancing needs peak. Companies must raise RMB550 billion in May just to replace maturing issues, with around RMB400-450 billion a month needed, thereafter.

Many fear an imminent "Lehman moment" as investors, banks and companies lose faith in each others financial viability, triggering a chaotic wave of debt defaults; the Renminbi would tumble, exporting domestic turmoil. Whilst increasingly possible, one has to imagine the incumbents will deploy their sizable financial reserves and policy influence to try and avoid such a disorderly outcome. Indeed, President Xi is unlikely to entertain any debt resolution that risks social unrest as he consolidates his hold on power in the run up to the 19th Party Congress in late 2017.

All of this suggests that China, with its aging population and chronic bad debts, risks a prolonged period of slower growth and disinflation, as politicians delay the pain of purging uneconomic debt (and companies) from the system. Echoes of Japan's lost decades abound. As a trade leviathan that accounts for 16% of world GDP, this suggests the global economic slowdown has further to run. This will prompt increasingly desperate efforts by Central Banks to reflate, challenging politicians to embrace similar fiscal experiments. It also means that, with corporate revenues and profits slumping, the equity rally from February lows looks increasingly optimistic.

IN OTHER NEWS...

After Tottenham squandered their lead to draw 2-2 with Chelsea on May 2nd, Leicester City were uncatchable at the top of UK Premier League. They were duly crowned champions. Having narrowly avoided relegation the year before, their triumph was wholly unexpected. Indeed, a few lucky punters managed to back Leicester to win the League at 5,000-1 at the start of the season; bookies are set to lose around £50m as a result (source: Corals). Amusingly, in August last year the bookies judged some other rather surprising outcomes as more likely, attaching the following odds to….

Simon Cowell to become UK Prime Minister	500-1
The Loch Ness Monster to be discovered	500-1
The Queen to have a Christmas number 1 record	1,000-1
Kim Kardashian to become US President	2,000-1
Elvis to be found alive	2,000-1

Gary Lineker, TV pundit, ex-player & Leicester supporter, tweeted in December that he'd present "Match of the Day" in his pants if Leicester won the title. The bookies are currently offering 2-1 on his pants being blue, with pink the outsider at 10-1……

EQUITIES

The International Monetary Fund recently downgraded its forecast for 2016 global growth from 3.4% to 3.2% and called for immediate action to prevent a recession. In its quarterly World Economic Outlook report it warned that growth had been "too low for too long". Despite this continued deterioration in economic news flow, equity markets have rebounded strongly from the February low, helped by a weaker US dollar and a rally in key commodity prices.

The headline MSCI World index gained a little over 1% last month in dollar terms. This was driven by two sectors: energy (+9%) and materials (+8%). In stark contrast, the technology sector, which has been a powerful driver of US equity returns over the past five years, was the worst performing; poor first-quarter earnings saw the sector post a 4% loss.

Healthcare stocks also struggled as the potential $160bn merger between Pfizer and Allergan collapsed following tough new tax rules from the Obama administration which aim to limit the benefit of “tax inversions”. Pfizer was seeking to shift the company’s tax base from the US to Ireland where Allergan is domiciled. This would have enabled Pfizer to escape US taxes on a significant amount of profits stored abroad. The collapse of the deal cost Pfizer $150mn in deal expenses and investment banks missed $350mn in foregone fees; the largest amount in M&A history.

The FTSE All Share index rose by almost 1% in April, led by a rally in mining stocks. During the first four months of the year Anglo American has rallied 150% and has been the best performing stock in the FTSE 100. The rebound in commodity prices has sparked a wave of short covering in resource stocks, yet despite many Chinese pronouncements about reducing over-supply we have not yet seen significant removal of capacity. Indeed, China’s steel output hit a record high in the first quarter. This adds weight to the argument that the recent rally has been driven mainly by technical factors, not improved fundamentals.

The MSCI Europe ex-UK index also enjoyed a 1% gain last month, led by Spain (4%) and Italy (3%). The Italian government announced a new banking rescue fund called Atlas, aptly named after the Titan who was condemned by Zeus to hold up the sky. The fund has so far raised a disappointing €4.25bn from a range of institutional investors and can provide capital to commercial banks cut off from “normal” private sector funding. According to the Bank of Italy, non-performing loans at Italian banks could be as high as €360bn, equivalent to a fifth of the country’s total economic output. Despite several short comings, the measure is a step in the right direction in addressing some of the banking system problems that are hampering Prime Minister Renzi’s economic reforms efforts.

Japan’s Topix index fell by -0.5% in April amidst a further downturn in economic activity. Falling household spending and weak trade has left the economy wholly reliant on fiscal support; the government continues to ramp up public spending and in late March agreed a record ¥97trn budget for the year to end April 2017. Prime Minister Abe has promised that much of the spending will be “front loaded.” Conversely, Bank of Japan (BoJ) Governor Kuroda disappointed investors by leaving monetary policy unchanged. Investors were spooked by the absence of a fresh fix of cheap money. Although we expect the BoJ to act again soon, there are no guarantees it will spur the market higher. Having further reduced our Japan holdings earlier this year we are in no rush to add back.

Emerging markets continue to benefit from the rebound in commodity prices and the weaker dollar. Although the headline MSCI Emerging Markets index was flat over the month, the more oil-sensitive markets, such as Brazil and Russia, rallied 8%. In Brazil, the lower House of Congress voted to impeach President Dilma Rousseff and the decision-making process now moves to the Senate. It is widely expected that Vice-President Temer will see out the remainder of the presidential term should Dilma be removed from power. Economic conditions remain extremely challenging in Brazil, but valuations of both the stock market and currency already reflect this reality. As a result, we deemed the late April pullback as an opportunity to add a modest Latin America exposure across all equity based mandates.

BONDS

The Federal Reserve left interest rates unchanged last month, but indicated that higher interest rates could be on the agenda at its June meeting. US growth continues to disappoint despite the accommodative monetary policy of the Federal Reserve; the first estimate of Q1 GDP was just 0.5% annualised. Business investment was again disappointing and there are signs the US consumer is flagging despite the strong tailwinds of a tight labour market and lower energy prices. Households have evidently saved, not spent, the “oil windfall”.

Should the Fed deem the recent rebound in domestic pricing pressures to be a credible inflation threat, June probably presents the final opportunity for a rate rise prior to November’s Presidential election. The Committee tends to refrain from action in the months preceding polling day to avoid accusations of political bias. The 10-year Treasury yield was little changed around 1.8% over the month.

As expected, the Bank of England Monetary Policy Committee (MPC) voted unanimously to keep interest rates unchanged last month. The minutes noted that EU referendum uncertainty was starting to weigh on economic activity. Governor Mark Carney weighed into the Brexit debate in a letter to the Treasury Select Committee, warning an “Out” could lead to higher inflation and lower economic growth. UK CPI inflation accelerated last month, from 0.3% y/y to 0.5% y/y, which caused the 10-year gilt yields to rise almost 0.2%, to 1.6%. If the sell-off continues we may look to add further to medium-term government paper.

Credit market defaults continue to rise. So far in 2016 corporate borrowers have defaulted on U$50bn worth of debt, whilst Standard & Poor’s reports that delinquencies (late payments) are rising at the fastest pace since 2009. Almost half of defaults have occurred within the stressed oil and mining industries, but the recent rally in commodity prices has seen some of near-term funding pressures ease. Within the US high yield market, energy sector spreads converged from 12% to 9% over the month, reducing the yield pick-up for the broader asset class from 7% to 6%.

In emerging markets, Argentina has successfully returned to international capital markets with the sale of U$16.5bn of debt across a range of maturities. The auction was a key test for the new, pro-market government of Mauricio Macri; demand was overwhelming with U$69bn worth of orders. It was only made possible by the payment of U$9.3bn to creditors from its previous (U$100bn) default in 2001. The issuance completes a remarkable turn-around for a country that is regarded as a serial defaulter.

CURRENCIES

The trade weighted US dollar index weakened almost 2% last month, bringing its year-to-date fall to nearly 6%. The weakness has been driven mainly by slowing US growth, but we suspect the prospect of a Trump presidency may also be starting to weigh on the currency.

The Bank of Japan’s decision to leave monetary policy unchanged spurred the Japanese Yen onto further gains; it appreciated by 6% in April to ¥107. Foreign investors have fled the country’s stock market and in doing so have unwound many of their currency hedges. This entails buying back the “short” yen positions, which in turn places upward pressure on the currency. A weak yen has been a key part of “Abe-nomics” and we believe the BoJ remains committed to reversing the recent gains. A successful debasement may require a different form of monetary intervention, but could also provide us with an opportunity to redeem what is now a very modest exposure to Japanese equities.

Brexit concerns have weighed on sterling since June 2015 with the currency falling from U$1.58 to U$1.38 at the end of February. However, since then the trend has partially reversed with markets pricing in a probable victory for the "Remain" camp.

The pound rallied another 2% to U$1.46 last month, having received a boost from President Obama's whistle-stop tour to London, during which he threatened that the UK would be placed at "the back of the queue" for a new trade deal should voters opt for exit. Betting markets place the odds of an exit in the 35%-40% range, whilst the polls indicate a much closer contest. We suspect the bookies will, as usual, prove the better forecasters, but we retain a dollar bias within sterling portfolios to help mitigate some of the near-term risk and volatility as we head towards the vote.

Emerging markets were among the best performing currencies last month, as the US dollar fell back. For the reasons outlined above, the Brazilian Real rose almost 5% against the US dollar. Although most developing nation currencies have enjoyed a healthy bounce from multi year lows, they still look attractive on longer-term charts.

GOLD/COMMODITIES

Oil prices have rebounded strongly since touching a multi-year low around U$30/barrel in January. Both US West Texas Intermediate (WTI) and European Brent rallied by over 15% in April with WTI rising to U$46/barrel and Brent to U$47/barrel. Last month's OPEC meeting in Doha ended in "no deal" despite high expectations for a cut in production levels. If anything, the cartel seems further away from agreeing new output quotas; Saudi Arabia refuses to engage with high cost producers like Venezuela and Russia unless Iran is party to any deal.

Unlike many industrial metals markets, the oil sector appears to be acting rationally to the two year slump by cutting future capital expenditure plans and trimming non-economic production. Wood Mackenzie estimates that U$400bn worth of capital expenditure has been postponed or cancelled since crude prices peaked in the summer of 2014. US oil output is already responding; daily production levels have fallen by over 550 thousand barrels from the April 2015 peak, to 9.1mn barrels. Given the supply glut of recent years, inventories remain elevated which suggests that a rebound to prior highs is unlikely in the near future. For oil at least, it would seem the maxim holds true that the cure for lower prices is lower prices.

Interestingly, Saudi Arabia has discussed plans to diversify the kingdom's reliance on oil revenues. Plans are afoot to list a small part of the state run oil company, Saudi Aramco. Floating just 5% of the entity would raise over U$100bn and would value the company at more than U$2 trillion, according to Deputy Crown Prince Mohammed bin Salman. Some of the proceeds would be used to establish a new sovereign wealth fund, akin to the Norwegian model. We also note that the Rockefeller Family Fund announced that it was divesting its coal, oil and gas holdings including Exxon Mobil (the firm is descended from the original family company, Standard Oil). Are these early signals from the core of the energy complex that a longer term structural shift is now underway?

Precious metals continued to perform well last month. Gold is witnessing its best start to the year since 1974, according to Bloomberg data. It rallied by 5% in USD terms during April and is now up 22% since the start of the year. We topped up our bullion exposure in March because it looks set to perform well in both "reflation" and "deflation" scenarios. If Central Bank efforts to engineer inflation seem to be succeeding, gold's effectiveness as a hedge against rising prices should come to the fore. Conversely, if persistent deflation forces the monetary authorities to reflate even more aggressively, gold should do well as fiat currencies are debased. Silver, which often acts as a leveraged play on the gold price, was up 16% last month.

Despite a supply glut, iron ore prices have surged this year; a 23% gain in April took the year-to-date ascent to an impressive 52%. The rally has been driven by frenzied speculative activity in the Chinese futures market with around U$330 billion of iron ore futures traded in Dalian in April. This was more than double the monthly turnover registered in February and roughly four times the amount spent trading physical iron ore internationally over an entire year. Fortescue's Metals Group CEO warned of the volumes being "so high that they swamp the physical market". With the authorities having clamped down on such "punting" in the Chinese stock market, it seems commodity futures are the new playground for debt-funded traders.

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.

	30-APR-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.4612	+1.8%	+2.6%	-4.8%
CHF	1.0424	+0.3%	+6.6%	-2.8%
AUD	0.7603	-0.7%	+7.3%	-3.8%
JPY	106.50	+5.9%	+13.9%	+12.3%
EUR	1.1451	+0.6%	+5.7%	+2.0%
BOND YIELDS (10 yr)				
UK	1.60	+0.18	+0.04	-0.24
US	1.83	+0.06	-0.09	-0.20
Germany	0.27	+0.12	-0.05	-0.09
Australia	2.52	+0.03	-0.12	-0.13
Japan	-0.08	-0.05	-0.18	-0.42
EQUITIES				
US. S&P 500 (USD)	2,065.30	+0.3%	+6.4%	-1.0%
UK. FTSE 100 (GBP)	6,241.89	+1.1%	+2.6%	-10.3%
MSCI Europe ex UK (EUR)	1,133.41	+0.9%	-0.6%	-12.5%
Japan. Topix (JPY)	1,340.55	-0.5%	-6.4%	-15.8%
China. Shanghai Comp (RMB)	2,938.32	-2.2%	+7.3%	-33.8%
HK. Hang Seng (HKD)	21,067.05	+1.4%	+7.0%	-25.1%
Australia. All Ords (AUD)	5,316.00	+3.2%	+5.1%	-7.9%
MSCI Pacific ex Japan (USD)	1,162.65	+1.9%	+12.6%	-14.8%
MSCI World (USD)	1,670.80	+1.4%	+7.0%	-6.1%
MSCI World (GBP)	1,142.35	-0.2%	+4.0%	-1.5%
COMMODITIES				
Oil (WTI)	45.92	+15.5%	+20.8%	-28.4%
Gold	1,292.99	+4.9%	+15.6%	+9.2%

DO YOU RECEIVE INVESTMENT VIEWS?

If you would like to receive a regular digital copy at the start of each month please email us at UK@bentleyreid.co.uk. Alternatively, Investment Views is available via the Bentley Reid App, which can be downloaded onto all Apple devices.

Instructions for downloading the Bentley Reid App on Apple devices:

1. Scan or click the QR code below, or search for 'Bentley Reid' in the Apple App Store. Note the search must take place in the 'iPhone Apps' section, which sits at the top of the screen, regardless of the device being used. If you search in the 'iPad Apps' section no results will appear.

2. Install the app and click 'Open'.

3. Once the app is installed, to ensure you receive a pop up notification that new publications have been posted, go to the general 'Settings' section on your device and then choose 'Notifications'. Scroll down on the right hand side and select Bentley Reid. In the 'Notification Center' section choose 'On,' the type of 'Alert Style' you would like and then return to the main screen.

Your BR App will now be ready to receive the latest Investment Views and Fund Factsheets.

CONTACTS AND REGULATION

Published and distributed in UK by **Bentley Reid & Co (UK) Limited**
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
Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
24 Floor Diamond Exchange Building, 8-10 Duddell Street, Central, Hong Kong,
Tel +852 2810 1233, Fax +852 2810 0849, Email HK@bentleyreid.com
Licensed by the Securities and Futures Commission in Hong Kong