



BENTLEY REID



# INVESTMENT VIEWS

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“Remain” or “Leave”? The simple yet vexatious question that will be addressed on June 23rd. Having joined the European Community under Ted Heath’s Conservative government in 1973, the Brits are being asked whether their current EU engagement should endure. If the vote to remain triumphs, short term relief will surely give way to a cold appraisal of the current UK economic state. With growth stalling and inflation absent, any equity market euphoria should be short lived. Conversely, if leave carries the day, the 24<sup>th</sup> June will be a day of intense global market volatility; until the path to Brexit is clearer, equity markets may struggle.

Neither short term reaction is a reason to vote “in” or “out”; the choice is of generational significance, making such short term considerations of little import. Of more interest are the wider implications for the European Union and the euro. Whatever the outcome of the pending plebiscite, the Eurozone is an increasingly fragile construct in its current form.

The Eurozone is not a fully-fledged currency union like the United States. The member states have not signed up to full fiscal and monetary integration, leaving the euro open to intense periods of existential stress. Put simply, having given up their ability to control domestic monetary policy and to influence their currencies, member states must rely on transfer payments during periods of economic stress; they cannot simply devalue their currencies to restore competitiveness. The strong (Germany) must pay for the weak. If the transfer payments are not forthcoming, the only way to address unproductive, recessionary periods is to endure painful episodes of deflationary austerity and societal reform.

We were reminded of this last month when, despite IMF demands for Greek debt forgiveness, Germany refused to countenance such steps. The Greek economy has shrunk for 7 of the last 8 years, unemployment sits at 24% and debt to GDP now stands at an eye watering 175%. Attaining a level of sustainable Greek debt is a Sisyphean task, absent realistic debt write downs. Greece is in a depression.

Lest we damn the Hellenic Republic as the only troubled child, Italy (which accounts for 12% of EU GDP) illustrates similar traits. The country labours under a government debt burden that has risen from 99% of GDP in 2007 to 133% today (*source: Eurostat*). Unemployment remains stubbornly high at 12% and banks are crippled by a stock of bad loans. At the start of the year, non-performing loans accounted for 17% of the total, equivalent to 21% of Italian GDP by value. Given that growth has stalled at a 1% annualised rate, it looks increasingly possible that Italy could follow Greece into intensive care. Moreover, with over €2.2 trillion of Government debt outstanding, the debt pile could rapidly become unaffordable. Imagine the impact if the current 1.4% yield, on 10 year Italian government bonds, rose to reflect a more disturbed outlook.

Despite the best efforts of the European Central Bank and its negative rate policy, EU growth has stalled and deflation is becoming entrenched. Unemployment remains stubbornly high with youth unemployment a chronic problem; 39% or more of those aged under 25 are unemployed in Italy, Spain and Greece, with a quarter of French youth without work.

Growing armies of EU citizens have become financially disenfranchised. Faced with this reality and the waves of immigration, it is no surprise to see the rising popularity of political extremes. The electorate has lost faith in mainstream parties and is blaming immigrant numbers for part of their woes. Even though Mr Hofer of the far right Freedom party failed to win the Austrian Presidency last month, he only fell short by 0.3% of the vote. This electoral shift will surely find echoes in France and Germany next year, when the likes of Marie Le Pen and the AfD participate in national elections.

Just when the Eurozone needs to integrate further to address its problems, nationalism is on the rise; local political parties reflect this in their policies and behaviour. Indeed, Britain is not alone in questioning its EU membership; 58% of Italians and 55% of the French would also like a referendum (*source: Gavekal*).

It thus seems that, “Leave” or “Remain”, the EU is heading for a moment when it has to decide on its future. Do member states commit to a truly Federal reality, sacrifice local independence, and try to create an enduring “United States of Europe”? Alternatively, do the weak and the strong go their separate ways? Given the local imperatives, the divergent social models and the influence of history, a smaller Eurozone made up of the stronger, core nations looks increasingly likely.

In this context, the 23<sup>rd</sup> June referendum seems to offer Britain a choice. Stay in the EU and accept the costs of the coming storm as the price of influencing the future shape of the union. Alternatively, step back, re-establish independence and revisit the EU experiment once the dust settles. In truth, both outcomes are sub-optimal and promise uncertainty. Damned if you do & damned if you don't?

## **IN OTHER NEWS...**

“The Washington Post Mensa Invitational” list has been doing the rounds for several years. The list is meant to be a compilation of readers’ replies to the papers invitation to alter a word by adding, subtracting or altering one letter to create a new definition. The list actually has nothing to do with the Washington Post and has changed little over the years; we share a few of the words below (with thanks to the friend who emailed it over).

*Giraffiti* – Vandalism spray-painted very, very high

*Sarcasm* – The gulf between the author of sarcastic wit and the person who does not get it

*Beelzebug* – Satan in the form of a mosquito that gets into your bedroom at 3am and cannot be cast out

Intoxication – the euphoria of getting a tax refund, which lasts until you remember it was your money to start with

*Reintarnation* – coming back to life as a hillbilly



## EQUITIES

A number of US Federal Reserve officials, including Chairwoman Yellen, are talking up the prospect of a summer rate rise. They believe the American economy can cope with a slightly higher cost of borrowing. We have our doubts about the strength of US GDP but markets are now pricing in a 20% probability of a June hike and evens for a change at the July meeting. This vote of confidence helped the S&P 500 post a 1.5% gain last month.

The US dollar benefitted from higher rate talk, adding 3% on a trade-weighted basis. This triggered a reversal of equity trends that have dominated this year; emerging market stocks saw profit-taking with Latin America bearing the brunt. Brazil's Bovespa index fell 10% as the on-going anti-corruption probe immediately ensnared members of the new Government.

Energy names also softened despite the continued oil price recovery; Brent and WTI crude traded above U\$50/barrel for the first time since November. The MSCI Energy sector drifted 3% lower, but is still 10% higher year-to-date.

Finally, Chinese stocks struggled due to disappointing economic data and slower credit growth. M1 money supply is still growing at 23% year-on-year, but shorter term data suggest the first-quarter credit surge has peaked; the impact of recent fiscal and monetary support is already waning. Gauges of "old" China activity are reinforcing the gloomy outlook; industrial production and fixed asset investment growth both came in lower than forecast in April. Given its role as the key marginal consumer of many industrial commodities, this posed a headwind for mining stocks with the MSCI Materials index falling 4% over the month.

On the plus side, Healthcare and Technology stocks returned to form last month despite a generally weak tone to corporate earnings. In the US, first quarter profits for large-cap listings fell by 7% over the year. A 107% collapse in energy earnings stands out, but the slowdown is broad based; 6 out of 10 sectors produced lower annual earnings. The profits recession is a key reason for our cautious outlook on US equities.

US bank stocks were boosted by the Federal Reserve's "hawkish" comments. The rise in short-term rates created a flatter yield curve, which would typically undermine banks' business models; they profit by borrowing from short-term depositors and lending at higher, longer-term rates. However, with so much excess capital sat on commercial bank balance sheets, a rise in short-term yields significantly boosts returns when they invest surplus funds into money market instruments. This, coupled with cheap valuations, explains why several of our active managers have benefitted from a bullish stance on US banks.

The stronger dollar also aided European and Japanese bourses as local currencies softened. The euro fell by 3% over the month as deflation worries offset better than expected economic news; Eurozone GDP expanded by 0.5% over the first quarter, the fastest pace in a year. Though the

headline rate remains anaemic, all the “core” countries posted stronger quarterly growth. Even the beleaguered French economy managed a 0.6% advance, led by household spending and investment. With the European football championships set to be disrupted by country-wide strikes against Hollande’s labour reforms, economic momentum looks fragile.

Sentiment surrounding European stocks was further boosted when Greece secured another debt deal with its creditors; Eurozone ministers agreed to disburse €10bn from the bailout fund, enabling the Greeks to meet their July debt obligations. Even though the deal included loan maturity extensions and an interest rate cap, tension between the Europeans (read Germany) and the IMF are intensifying. Lagarde’s IMF is refusing to provide additional financing unless some form of debt cancellation takes place; with total debts of €300bn, or 180% of economic output, the IMF believes (correctly) that Greece will be unable to pay all its liabilities. A reprise of the “Grexit” debate may well replace “Brexit” before too long.

The FTSE 100 index was flat in May as losses in mining and energy names offset a strong performance by the housebuilder and the insurance stocks. The latter sectors benefitted from polls that indicated a growing lead for the “Remain” camp in the June 23<sup>rd</sup> referendum. Indeed, Ladbrokes now offers 4-to-1 against a “Leave” victory.

With UK shares now pricing in a high probability for “Remain”, a Brexit (or heightened fears thereof) would likely trigger a sharp fall in UK (and global) stock markets. Though “Remain” continues to be the most likely outcome, our low equity exposure and pro-US dollar stance provide a degree of portfolio protection should the unexpected occur. Any correction, if amplified by fear and panic, could well provide us with a buying opportunity.

In Japan, a 4% decline in the Yen underpinned a 3% advance from the Topix. The rally unfolded despite stubbornly entrenched deflation and weak economic and corporate news; over the first three months of the year company profits fell by 7%.

After contracting in the final quarter of 2015, the Japanese economy grew by 0.4% in the first quarter. However the improved activity was overly reliant on the public purse; Government spending rose by 0.7% over the period whilst the private sector stagnated. As we have noted before, both consumers and businesses seem spooked by the evident loss of “Abe-nomics” momentum. Indeed, acknowledging the challenge, on 1<sup>st</sup> June, Prime Minister Abe confirmed a 2 ½ year delay to the April 2017 sales tax hike, having failed to secure a coordinated global fiscal response at last month’s G7 meeting. Despite the sluggish economy, Abe’s popularity amongst the electorate should secure a win at next month’s Upper House elections.



## **BONDS**

Of the major government bond markets, only US Treasuries posted a loss last month. Yields rose across the curve, as talk of a US summer rate rise intensified. The most pronounced move came at the short-end. The 2-year Treasury yield rose by 0.10%, to 0.88%, its worst monthly performance since December. Conversely, yields headed lower (and prices higher) on UK, European and Japanese sovereign paper.

Recent economic developments in the US have been mixed. On the plus side, April retail sales grew by a stronger than expected monthly rate of 1.3%, partially offsetting declines in both January and March. Overall, the US consumer has had a weak start to the year and must now contend with rising

gasoline and food prices. Positive results from the housing market also boosted sentiment; demand for previously owned homes remained firm whilst new home sales, which represent 10% of total transactions, spiked by 17% to the highest level since 2008.

Other parts of the economy are not faring so well. Forward looking purchasing manager indices (PMI) for the manufacturing sector suggest industrial activity is deteriorating again, whilst weak corporate investment figures offer little future promise; April core capital goods orders fell at an annualised pace of 5%. Initial jobless claims have also been rising, suggesting the labour market could be losing momentum. This is likely to be a concern for Chairwoman Yellen, who has consistently cited employment metrics when considering possible rate rises.

In the UK, gilt yields fell in May as economic activity slowed and Brexit uncertainty lingered. It is difficult to judge how the asset class will perform if a “Leave” vote materialises; domestic safe haven buying could be swamped by overseas sellers. Referendum uncertainty has contributed to a pronounced UK economic slowdown; both service and manufacturing PMIs have eased with the latter now contracting. New export orders have fallen for four consecutive months, suggesting both the domestic and external sectors are challenged.



## CURRENCIES

All major currencies fell against the US dollar last month. The worst performer was the Aussie dollar, which depreciated by 5% as commodity prices fell and Q1 inflation came in at -0.2%. The first quarterly price decline since late 2008 prompted the Reserve Bank of Australia to cut its target rate by 0.25% to a new record low of 1.75%;

further cuts are likely.

In the UK, sterling finished the month 1% lower against the dollar at U\$1.45; in a similar vein to UK equities, early month weakness gave way to a second-half rally as Brexit fears eased. As noted above, we believe that political and economic risks are skewed to the downside for the UK economy and the pound even if “Remain” carries the day.

The People’s Bank of China (PBoC) responded to the Federal Reserve’s less dovish tone by orchestrating a 1.6% depreciation of the onshore renminbi last month. A similar move in December caused panic-selling of risk assets at the start of the year. This time round, markets appear relaxed (even complacent) over the competitive, deflationary threat posed by a weaker Chinese currency. Despite the modest depreciation against the US dollar, the renminbi has quietly fallen against its other major trading partners. The yen and the euro have risen 19% and 8% respectively against the renminbi over the last 12 months.

A cycle of Central Bank engineered competitive devaluations is now underway. Indeed, last month the US Treasury department declared that 5 of its largest trading partners – China, Japan, Germany, Taiwan and Korea – may be guilty of some form of currency manipulation. With growth weak everywhere, these tensions are set to intensify.



## GOLD/COMMODITIES

Agricultural commodities and oil were the exceptions to a generally weak month for resource markets. The WTI oil price added a further 5%, finishing May at U\$49/barrel.

The oil rally has, in the main, been driven by supply side factors. US production continues to decline with the Baker Hughes oil rig count touching 400 last month, down from a 2015 peak around 900. US output has fallen by 850,000 barrels per day since April last year.

Transitory supply shocks have amplified the price rally. Energy Aspects, an independent consultancy, estimates the combined impact of the Alberta wildfires, conflict in the Niger Delta and power outages in Iraq is a loss of 3.5 million barrels from a daily supply of 90 million. Conversely, OPEC shows no sign of production cuts; the cartel's daily output has reached an 8-year high of 32.6 million barrels.

Despite rebounding energy prices, it seems a matter of “when” not “if” Venezuela defaults on its debt obligations. The economy is on course to shrink by 8% this year and government employees have been placed on a 2-day working week in a bid to stop power blackouts. Social unrest has been fuelled by a shortage of basic goods and rampant inflation, which the IMF estimates will exceed 1,600% by 2017. With oil accounting for 98% of total exports, the government is desperately short of funds. To help plug the gap, Bloomberg notes the country sold 16% of its gold reserves in the first quarter, following a 24% reduction last year. This was the largest sale by a Central Bank since the Swiss sold over 3 million ounces in late 2007.

Turning to gold, bullion fell 6% last month to U\$1,215/oz, as the prospect of higher US rates raises the opportunity cost of holding gold. The sell-off has not dampened our enthusiasm for bullion; we believe it offers protection against both the currency debasement inherent in a deflationary, currency war and any inflationary surprise. We also take comfort from long-term price charts that suggest a lot of technical support at the U\$1,200/oz level.

## NEWS & VIEWS

### Bentley Reid Investment receives the Asset Risk Consultant 3D award

We are pleased to announce that Bentley Reid investment management have been presented with Asset Risk Consultants (ARC) 3D Award. ARC's 3D Award is an independent endorsement of Bentley Reid's commitment to the principles of transparency, engagement and integrity. In an evolving investment climate, we recognise the importance of this independent validation.



We continue to contribute our performance data to and are members of the Trustee Managed Portfolio Indices (TMPI). These independent indices seek to inform the Trustee and are endorsed by the Society of Trust and Estate Practitioners (STEP).






For further information please do contact us or visit:

ARC website at [www.assetrisk.com](http://www.assetrisk.com)

TMPI website at [www.trusteempi.com](http://www.trusteempi.com)

## 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
	UK, EUROPEAN, JAPANESE, AUSTRALIAN, DEVELOPING, RESOURCES, HIGH YIELD, 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-MAY-16	1 MTH	3 MTH	12 MTH
<b>CURRENCIES (VS USD)</b>				
GBP	1.4483	-0.9%	+4.1%	-5.3%
CHF	1.0061	-3.5%	+0.5%	-5.4%
AUD	0.7234	-4.9%	+1.3%	-5.4%
JPY	110.73	-4.0%	+1.8%	+12.1%
EUR	1.1132	-2.8%	+2.4%	+1.3%
<b>BOND YIELDS (10 yr)</b>				
UK	1.43	-0.17	+0.09	-0.39
US	1.85	+0.01	+0.11	-0.28
Germany	0.14	-0.13	+0.03	-0.35
Australia	2.30	-0.21	-0.10	-0.43
Japan	-0.12	-0.04	-0.06	-0.51
<b>EQUITIES</b>				
US. S&P 500 (USD)	2,096.96	+1.5%	+8.5%	-0.5%
UK. FTSE 100 (GBP)	6,230.79	-0.2%	+2.2%	-10.8%
MSCI Europe ex UK (EUR)	1,151.18	+1.6%	+4.3%	-11.1%
Japan. Topix (JPY)	1,379.80	+2.9%	+6.3%	-17.6%
China. Shanghai Comp (RMB)	2,916.62	-0.7%	+8.5%	-36.8%
HK. Hang Seng (HKD)	20,815.09	-1.2%	+8.9%	-24.1%
Australia. All Ords (AUD)	5,447.80	+2.5%	+10.1%	-5.7%
MSCI Pacific ex Japan (USD)	1,128.42	-2.9%	+10.1%	-14.7%
MSCI World (USD)	1,674.61	+0.2%	+8.2%	-5.9%
MSCI World (GBP)	1,153.71	+1.0%	+3.7%	-1.0%
<b>COMMODITIES</b>				
Oil (WTI)	49.10	+5.2%	+29.9%	-21.7%
Gold	1,215.33	-6.0%	-1.9%	+2.1%



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