BENTLEY REID

INVESTMENT VIEWS

JULY 2016

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EQUITIES	:	Europe & Japan bear brunt of Brexit sell off
BONDS	:	Core Government yields tumble to record lows
CURRENCIES	:	Sterling collapses as the Yen drives higher
COMMODITIES	:	Gold rises in all currencies

During the brutally divisive Brexit referendum, we were told that a Leave outcome would free up an extra £350m a week to spend on the NHS. We were also informed that Brexit would trigger an emergency budget to fill a £30bn fiscal black hole that would leave us all £4,300 worse off each year. What a load of abject, risible, self-serving tosh from both camps.

Besieged by a torrent of implausible claims from all sides, UK voters were left to rely on emotion, not facts, when coming to a conclusion; the paucity of decent debate gave airtime to the extreme views of both factions. The political class failed its constituents with interventions by the likes of Obama and the IMF suffering a similar credibility deficit.

Stepping back from the emotion that surrounds the outcome, we do not expect a second referendum (or the equivalent via an early general election). If other restless elements (eg. the Netherlands and Sweden) gain enough traction to demand greater flexibility on the issue of immigration, it is possible that a new EU approach to this delicate topic appears. This could, in theory, be presented to the UK before it triggers the Article 50 leave process, eliciting a vote to remain. We doubt this will happen. More likely, mutual self-interest will inform a multi-year negotiation that shapes the future EU/UK relationship. A UK excommunication suits neither side; a political compromise seems likely. Furthermore, despite the trenchant forecasts of the politicians and media, the final detail is unlikely to appear until after the 2017 German and French elections; until then, Merkel and Hollande will speak to a domestic audience when they address the UK's departure.

As for the impact on asset markets, the first thing to note is that no one really knows; anyone who claims clarity of foresight is probably still arguing their side of the debate. Whilst acknowledging this reality, our views are little changed from before the vote.

Prior to the referendum, Europe faced an existential crisis. Slow growth, indebted Italian banks, the Greek crisis, chronic youth unemployment and tensions between the "rich" north and "impoverished" south; all of these challenges existed before, and did not change on, June 23rd. The Brexit vote has, however, shone a light on such matters and the growing number of financially disenfranchised. Brussels leaders must now react to the concerns of their electorates; there must be further structural reform in the indebted nations and greater fiscal latitude. We wonder if such a fine balancing act is possible. Germany does not want greater fiscal spending by indebted nations without evidence of reform. However the indebted (Italy, Portugal and Spain in particular) desperately need fiscal spending to salve their restless electorates. Which side of the argument compromises? Only time will tell but we expect the EU to slow further with deflation an omnipresent concern, despite the best efforts of the European Central Bank.

In the UK, the ongoing uncertainty will surely delay hiring and corporate investment. That said, export businesses will be boosted by sterling's fall, base rates will remain anchored near zero and the UK will have uninterrupted access to EU markets for the next 2 or so years. Our best guess is that the UK continues its gradual slowdown, against a backdrop of recession anxiety.

Further afield, absent a banking crisis in the EU, Brexit should have a muted impact. This is just as well as the troubles in Japan and China remain self-evident. These economies continue to slow with the Renminbi resuming its decline. Over the last 12 months the offshore Renminbi has fallen 7% against the dollar and the Euro, whilst sliding 22% against the Yen. This is deflationary for the world as a whole and any signs that this prompts a resumption in capital outflows from China would not be well received.

In the US, there are also signs that the economy is sluggish. July 8th sees publication of June's non-farm payroll figures (a form of employment data). If these confirm May's sharp slowdown, whispers of a US recession will grow. Pending second quarter corporate earnings announcements will serve to confirm or challenge such data. We sense a gradual slowdown is unfolding in the US, with risks skewed to the downside.

Brexit has reinforced our view that the global economy is decelerating despite the increasingly desperate efforts of Central Banks. We suspect this loss of momentum will intensify, eliciting further monetary measures; the marginal benefits of such steps are now questionable. Under this scenario, equity markets will remain vulnerable to unexpected shocks and a final, coordinated fiscal response from major world powers looks increasingly necessary and possible.

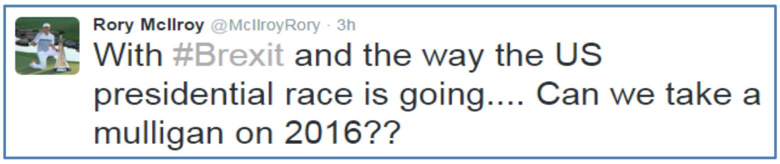
We are thus happy to retain our defensive asset bias that has worked well this year. That said, during periods when fear trumps rationality, we are looking to buy long term exposure to sectors that favour innovation (think tech and healthcare); assets that offer a real return and regions or sectors that benefit from good demographics and low debt levels.

IN OTHER NEWS…

Having fought Parkinson's for 32 years, June saw the passing of Muhammad Ali, aged 74. Cassius Marcellus Clay (as he then was) won a gold medal at the 1960s Olympics, aged 18; he went on to be the most celebrated boxer of all time. An inspiring, controversial and polarizing figure both inside and outside the ring, we share below our favourite of his many, memorable quotes:

"I done wrestled with an alligator, I done tussled with a whale, handcuffed lightening, thrown thunder in jail; only last week I murdered a rock, injured a stone, hospitalised a brick. I'm so mean I make medicine sick!"

And finally, we share an amusing tweet from Rory McIlroy after the Referendum result:



EQUITIES

At its intra-day nadir, Britain's shock decision to leave the EU wiped more than $2 trillion off global equity markets on Friday 24th June. This was the largest daily loss ever according to S&P Dow Jones. UK banks and housebuilders were in the eye of the storm. Taylor Wimpey and Persimmon were both down by over 40% at the market open, whilst Lloyds and RBS fell by over 30%; the latter recovered about a third of their losses by the close. Surprisingly, markets were quick to recover their footing with the FTSE 100 index of large UK companies ending the month 4% higher. The sharp decline in sterling will boost the value of overseas earnings in dominant FTSE100 sectors such as pharmaceutical, tobacco and gold miners. However, more domestically oriented mid and small company stocks fared much worse; the mid cap FTSE 250 index was down 5% for the month.

Peripheral European markets such as Spain (-10% in June), Italy (-10%) and Greece (-16%) were amongst the worst affected. Political commentators immediately questioned whether Europe would see a wave of similar referenda under various pithy titles such as Departugal, Italeave and Austria La Vista. There is real concern that the weaker European banks (Italian, in particular) may need to be rescued if uncertainty undermines growth, thereby exposing their indebted balance sheets. The Stoxx Europe 600 Banks index fell by 18% in June. Italy's Monte dei Paschi fell to a new low after the European Central Bank (ECB) demanded a reduction in its non-performing loans from €46.9bn to €38.9bn by the end of 2017 and €32.6bn by the end of 2018.

In the US, despite a 6% mid-month fall, the S&P 500 ended June little changed. Energy stocks continued to rally as the dollar firmed and the price of oil stabilised around $50. A couple of headline grabbing M&A deals also helped. Microsoft bid $26.2bn for LinkedIn, valuing the latter at 79 times EBITDA (earnings before interest, taxes, depreciation and amortization); that makes it the most expensive all cash deal ever for an internet company (source: Bloomberg).

The Japanese market was undermined by the general malaise and the strength of the Japanese Yen. Safe haven buying pushed the currency up from ¥110 to ¥103 (versus the dollar) whilst the Topix index fell by 10%. Again, financial stocks and banks were amongst the worst performing sectors, as investors fretted about the negative impact of a slowing domestic economy and further monetary stimulus. Negative rates have already damaged bank profitability.

Elsewhere, emerging markets (EM) rallied, reacting positively to the Federal Reserve's decision to postpone US rate hikes indefinitely; cheap dollar funding tends to help EM sentiment and activity. Brazil was one of the star performers with the equity market up 6% and the currency rising 11% against the dollar. Although Brazil is in the midst of its longest recession since the 1930s, the stock and currency markets have priced in a lot of bad news; both seem to have reached oversold levels. We thus used the recent market volatility as an opportunity to add a modest exposure to the Findlay

Park Latin America fund across all mixed mandates; we have owned the fund for growth oriented mandates since late 2015.

Finally, it was noteworthy that the MSCI delayed adding China's A-shares to their EM index until 2017. The limit on repatriation of capital from China is a particular sticking point. However, MSCI did leave the door open for a swift change of heart "should further significant positive developments occur ahead of June 2017."

BONDS

Core government bond yields moved further into bubble territory this month as yields plummeted (and prices rose) in reaction to Brexit and the deteriorating global economic outlook.

In the aftermath of the Brexit vote, Bank of England Governor Mark Carney said that he would not hesitate to take "additional measures as required" and was ready to provide £250bn of funds to institutions to ensure financial system liquidity. It now seems likely that the next UK rate move will be a cut and that this could arrive during the summer. UK government bond prices rallied hard as the UK yield curve flattened. 10 year government bond yields fell from 1.43% to 0.87%, whilst 5 year yields tumbled from 0.90% to 0.35%. The rally in index linked bonds was even more acute due to the inflationary impact of sterling's weakness; imports become more expensive as the currency slides. Index linked Gilts added 10% during the month. The market strength unfolded despite both Standard & Poors and Fitch downgrading Britain's credit rating to AA. Both cited a likely deterioration in the country's economic performance, including its important financial sector, as reasons for the move. We have around 20% allocated to nominal and index linked bonds in Sterling Balanced portfolios and remain holders at these levels.

The US Treasury market saw similar moves. The 10 year yield fell from 1.85% to 1.47% whilst the 5 year yield dropped from 1.37% to 1.00%. Though Treasuries benefitted from safe haven buyers, US economic data continues to be weak. Markets were spooked mid-month by very low job growth; non farm payrolls rose 38,000 in May, compared to forecast growth of 162,000. Another disappointing jobs print on 8th July could be an interesting test of fragile sentiment. US retail sales also slowed, gaining 0.5% in May versus 1.3% in April. Encouragingly, credit spreads remained largely unchanged during the month. The yield on high yield bonds, versus Treasuries, remained around 6%, with the more volatile energy bonds trading at an average spread of just under 8%. We still believe that large parts of the credit market are illiquid and fragile; any signs of distress would be cause for concern.

Eurozone economic growth was revised up to 0.6% this month although deflation remains evident. May was the fourth month of annualised deflation, coming in at -0.1%. Even with weak energy and transport prices excluded, the core inflation number only registered 0.8%. As a result, the 10 year German bond yield moved from 0.14% into negative territory; it ended June at -0.13%. The Negative Interest Rate Policy of the ECB and the Swiss National Bank has driven core EU bond yield towards/below zero, with all Swiss government bonds now offering negative yields. We struggle to understand how this can endure without serious repercussions.

In emerging markets the Mexican central bank announced a surprise 0.5% hike in its benchmark interest rate. The move is an attempt to contain inflation and shore up a currency that has fallen prey to global macro traders. In Brazil, the central government has offered $15 billion of emergency debt relief to state governments through 2018 to help boost the quality of public services. Brazil also approved an emergency loan to Rio de Janeiro to help prepare for the Olympics. Finally, the Governor of the Reserve Bank of India, Raghuram Rajan, announced his decision to step down. He has been credited with restoring the country's macroeconomic stability, but has come under increasing fire from some politicians for not doing enough to boost economic growth with looser monetary policy. Sadly, short term political imperatives have trumped long term monetary prudence.

CURRENCIES

The first half of the month saw sterling rally from $1.45 to $1.50 on the eve of the referendum, as investors anticipated a Remain triumph; sterling thus fell precipitously to $1.32 on Friday 24th June. This was the lowest value against the dollar since 1985. Cable ended the month at $1.33, a fall of 8%. Sterling was down a similar amount versus the euro which fell 0.2% against the dollar. ECB President, Mario Draghi, warned that Brexit could reduce euro-area GDP by up to 0.5% over three years; that seems optimistic to us.

Conversely, the Japanese yen was one of the strongest world currencies, as investors bid up this traditional safe haven. It rallied 7% versus the US dollar to end June at ¥103. Finance Minister Taro Aso responded by stating that the authorities are prepared to "firmly respond" if currency market speculation drives the currency higher; the yen has now unwound all its (beneficial) losses since the start of Abenomics. According to the government, the estimated breakeven currency level for exporters this year is ¥103. This suggests that many large Japanese companies will struggle to be profitable for the balance of the year unless the yen softens. Though currencies are difficult to predict, we note that there has been a large increase in speculative net long positions in the futures market in addition to large outflows from foreign investors this year.

As noted earlier, the Brazilian Real rallied 11% versus the dollar this month. The currency has appreciated from a low of R$4.15 in January to R$3.21 at the end of June. The cheapness of the currency on a real exchange rate basis represents one important facet of the investment thesis for our Latin America exposure within portfolios. A recovery in the oil price and some agricultural products has also been beneficial this year. In contrast, Nigeria's currency plunged after the country removed its peg to the US dollar. The Naira dropped more than 40% after the central bank abandoned its commitment to defending the value of the currency at a fixed rate of ₦197 to the US dollar. The official currency finished the month at a rate of ₦280; the black market currency trades somewhat lower.

GOLD/COMMODITIES

Gold rallied 9% to $1,322/oz during the month, a gain of over $100. In GBP terms the return was even more pronounced (19%) as it benefited from sterling's weakness. We continue to believe that gold represents a valuable source of diversification to guard against currency debasement and unconventional monetary policy. Silver, that often acts a leveraged play on gold, was up 17% last month.

The oil price was marginally weaker in June with WTI crude at $48/barrel and Brent at $49. Iran has continued to ramp up production to 3.5m barrels per day. However, this has been more than offset by recent outages in both Nigeria and Canada plus a steady decline in US production. Global output is 590,000 b/d below this time a year ago and the International Energy Agency now predicts a balanced market by the end of the year.

Meanwhile natural gas prices leapt 22% this month, bringing an 8 year bear market to an abrupt halt. Hot weather in the US has boosted demand for air-conditioning in the midst of "injection season" when surplus supplies are pumped underground in preparation for winter.

In the agri space, corn and wheat prices remained weak as US planting acreage reports suggest another record year could be ahead of us; inventory levels are already elevated after a couple of bonanza years. Lower crop prices are having an impact on US farm incomes; crop receipts are estimated at $190bn this year, down a fourth straight year from $232bn in 2012. Sugar was one of the better performing agricultural commodities. It rallied 15% last month as sugar output in Brazil's Center-South region fell by 39% year on year as rain delayed cane crushing.

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, JAPANESE, AUSTRALIAN, DEVELOPING, RESOURCES, HIGH YIELD, TECHNOLOGY, HEALTHCARE	US, UK, AUSTRALIAN	
–	US, EUROPEAN	EUROPEAN, JAPANESE, CORPORATE, HIGH YIELD	

MARKET PERFORMANCE

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

	30-JUN-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3311	-8.1%	-7.3%	-15.3%
CHF	1.0245	+1.8%	-1.5%	-4.2%
AUD	0.7451	+3.0%	-2.7%	-3.3%
JPY	103.20	+7.3%	+9.1%	+18.7%
EUR	1.1106	-0.2%	-2.4%	-0.4%
BOND YIELDS (10 yr)				
UK	0.86	-0.56	-0.55	-1.16
US	1.47	-0.38	-0.30	-0.88
Germany	-0.13	-0.27	-0.28	-0.89
Australia	1.98	-0.32	-0.51	-1.03
Japan	-0.22	-0.10	-0.19	-0.68
EQUITIES				
US. S&P 500 (USD)	2,098.86	+0.1%	+1.9%	+1.7%
UK. FTSE 100 (GBP)	6,504.33	+4.4%	+5.3%	-0.3%
MSCI Europe ex UK (EUR)	1,091.65	-5.2%	-2.8%	-11.8%
Japan. Topix (JPY)	1,245.82	-9.7%	-7.5%	-23.6%
China. Shanghai Comp (RMB)	2,929.61	+0.4%	-2.5%	-31.5%
HK. Hang Seng (HKD)	20,794.37	-0.1%	+0.1%	-20.8%
Australia. All Ords (AUD)	5,310.41	-2.5%	+3.1%	-2.6%
MSCI Pacific ex Japan (USD)	1,135.08	+0.6%	-0.5%	-10.6%
MSCI World (USD)	1,653.23	-1.3%	+0.3%	-4.7%
MSCI World (GBP)	1,246.03	+8.0%	+8.8%	+12.9%
COMMODITIES				
Oil (WTI)	48.33	-2.4%	+16.9%	-22.1%
Gold	1,322.20	+8.8%	+7.3%	+12.8%

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