BENTLEY REID

INVESTMENT VIEWS

AUGUST 2016

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EQUITIES	:	The post-Brexit rally continues
BONDS	:	Gilt yields at fresh record lows, but JGB's sell off
CURRENCIES	:	Dovish Fed keeps the dollar in check
COMMODITIES	:	Gold edges higher as oil slumps
NEWS & VIEWS	:	UK Property Funds

Second quarter US growth came in at an annualised rate of 1.2%, less than half the anticipated level. Though this may be revised up at a later date as the volatile inventory component settles, there is no escaping the softer tone to US data during the first half year. Regardless, since the 1st of April the US stock market has risen 5% whilst profits have continued to tumble; they contracted at an annualised rate of 7% and 4% in the first and second quarter, respectively. This has pushed the trailing price/earnings ratio north of 23 times; an historically elevated level.

Other more prosaic US valuation metrics are also flashing red; Tobin's q (a measure of the stock markets value versus the cost of replacing the underlying companies assets) has only ever been more expensive in 1929 and 1999. CAPE, or the cyclically adjusted price earnings ratio, paints a similar picture (source: Smithers & Co). Finally, Warren Buffet's favoured measure, the total value of the US stock market compared to the size of the US economy, has only been higher once in the last 65 years; during the 1990's tech bubble.

This argues for lightening up on US equity holdings. That said, historically Tobin's q, CAPE and "Buffet's best" have not been particularly useful for short term market timing. Current levels suggest returns from US equities over the next decade will be muted, but stocks could go higher before they retrace. The question is how much higher? Are we in the throes of a 1999 type "melt up" when a small coterie of stock are bid up to crazy levels? Are consumer staples like P&G, Nestle and big Tobacco todays dotcom stocks?

There seems to be a growing acceptance that post-crisis emergency monetary policy, or QE, is reaching the limits of efficacy. The adverse reaction of markets to negative interest rate policies in both Japan and the EU has caused Central Banks to pause. With over $12 trillion of bonds now trading with a negative yield, it is not the cost or supply of money that is the problem. With an unsustainable debt overhang sapping global aggregate demand, it is consumption and investment that is failing to fire.

This has led to demands for a fiscal response, with Governments taking over from Central Banks as nursemaid to the economic recovery. With G20 leaders coalescing round the fiscal remedy, politicians are responding with large fiscal stimulus packages. Japan has announced up to ¥28 trillion of spending and investment over the next few years, whilst China has paused after pushing the equivalent of 25% of GDP into its economy in the first quarter. In the EU, under cover of the migration crisis, member states have quietly dropped budget discipline and are increasing spending. Finally, with the new UK Prime Minister rejecting ex-Chancellor Osborne's austerity and both US Presidential candidates promising Keynesian largesse, we are entering a period of global fiscal expansion.

This could well provide a fillip to nominal US GDP. However, with so much surplus money in the system, a sizeable fiscal expansion risks generating material inflation. Under such a scenario, increased aggregate demand could push depressed commodity prices higher, with wages rising due to tight American labour markets and pressing social imperatives (i.e. rising minimum wages). After a decade of sub-par investment, companies lack surplus capacity, suggesting rising input costs will quickly erode record margins. US equity prices, increasingly priced for perfection, would come under pressure even as GDP recovered.

Of course, if the current deflationary mind set remains, the fiscal stimulus will quickly fizzle out, as corporates and consumers continue to hoard cash and save. Under this scenario, both politicians and Central Banks can be expected to redouble their efforts as chronic global indebtedness and entrenched deflation would be the mother and father of a global depression.

Though equity markets may rise further on talk of Government action, our best guess is that global GDP continues to slow with little or no inflation pressures as initial fiscal measures lack ambition and take time to bite. As growth continues to decelerate, action will catch up with rhetoric as panicked Governments are forced to emulate Central Banks in the scale and reach of their spending programs. It is impossible to say if this will engender sustainable growth, with higher, controlled inflation; policy nirvana. To us, the risk of a price shock, either inflationary or deflationary, seems equally likely. Given such fundamental uncertainties, valuation remains our anchor. This suggests that the equity market rally should not be chased.

IN OTHER NEWS…

A couple of things that caught our eye this month.

Firstly, the Chilcot enquiry into the UK's role in the Iraq war. Announced by Gordon Brown in 2009 and published on the 6th July this year, the long-delayed report reads as a damning indictment of the Blair Government, a deficient case for war and inadequate post-conflict planning. The report stretches to 12 volumes and retails for £767 (including the free executive summary!). The tomes contain 2.6m words, compared to the Bible (0.8m), War & Peace (0.6m) and the entire Harry Potter series (1m). It also trumps the longest book ever written, a 17th century romantic novel credited to Georges de Scudéry. A Richelieu acolyte, his book ran to 2m words. Chilcot's epic would take about 9 whole days to read.

On a lighter note, Apple surprised with some better than expected numbers. Its prodigious pile of cash and long term securities now stands at $232bn, enough to buy Uber, Tesla, Twitter, Airbnb, Netflix, Snapchat and SpaceX and still have $21bn of change (source: Twitter 27.7.16). Set in context, their 2.2% dividend seems a little stingy....

EQUITIES

A month on from Brexit and politics continues to dominate financial markets. In Britain, Theresa May's expedited appointment as UK Prime Minister helped settle immediate concerns about a potential power vacuum; longer-term questions remain about the British exit negotiations. Significantly, the Labour Party's civil war affords the new Tory leadership time to consider policy options and distance itself from the Cameron/Osborne era. All in all, a more stable outcome than looked likely on June 24th.

Across the Atlantic, the convention season has concluded and the Presidential race is underway. Given pervasive voter apathy and deeply unpopular candidates, the vitriolic relationship between Clinton and Trump will surely throw up headline grabbing campaign promises between now and the November 8th vote. Markets may well be unsettled and American companies have already increased their precautionary cash holdings, according to a survey of corporate treasurers. That surely bodes ill for future business investment levels.

Despite all this noise, it was a decent month for equities as the post-Brexit bounce continued. With the exception of energy stocks, which followed the oil price lower, gains were widespread. The MSCI World equity index rallied by 4% in dollar terms.

In the UK, the FTSE 100 added 3% in July with mid and small-cap companies (the FTSE 250) rebounding over 6%. They have now clawed back all of their post-referendum losses. In a similar vein to the large-caps, the more domestically focused firms have lagged those with overseas operations. The latter have benefited from sterling's slump, boosting the value of overseas revenues and making exports more competitive.

The soft pound has also encouraged M&A activity, as cash-rich foreign firms take advantage of their enhanced buying power. Last month saw Japan's SoftBank acquire Cambridge-based ARM, the smartphone chip designer, at a 43% premium. Further bids for UK "market leaders" are likely.

The broader "risk on" trend stems mainly from the hope that fiscal and monetary policymakers will conjure up new methods to offset waning global growth. The recent rally has taken place against a backdrop of sluggish activity in both emerging and more advanced economies meaning headline valuations remain unappealing.

As we have mentioned before, additional Central Bank support will not necessarily be well received by markets. Japan is a case in point. Last month saw the Bank of Japan (BoJ) disappoint investors by rejecting "helicopter money" (Central Bank funded government spending). Instead, the BoJ opted to double the rate of equity purchases to ¥6 trillion each year, a relatively modest step. We struggle to see how this stems the "real world" contraction in retail sales and industrial production.

Regardless, the Topix was one of the better performers with a monthly gain of 6%. It rallied strongly in response to Prime Minister Abe's decisive victory in the Upper House election, which saw his coalition party secure a two-thirds majority. This will enable him to deploy even more fiscal stimulus;

a multi-year ¥28trn package of infrastructure investment and low cost loans has since been announced. We have become increasingly concerned about the economy's continued decline in the face of such large-scale intervention and have used the rally to switch our Japan exposure to Latin America in all bar the growth portfolios.

In the US, dovish comments from the Federal Reserve and a slightly better-than-expected earnings season drove the S&P 500 index to an all-time high of 2,175. It added 4% over the month. However, a profits recession remains in train with US earnings declining at an annual pace of 4% in the second-quarter; the "positive surprise" stems from the fact profits were forecast to fall by 6% before the first results were announced.

In absolute terms, corporate America is struggling with profits shrinking in 6 out of 10 sub-sectors. The worst performers are the energy firms, which saw earnings slump 86% over the past year. Conversely, the consumer discretionary sector has fared well with 9% growth. This was skewed and flattered by Amazon, driven by rapid growth in the firm's cloud business and less investment spending. Its earnings increased 9 fold.

The European bank stress tests were announced at the month-end. The process was a predictable fait accompli with all bar one of the institutions deemed to have sufficient capital to withstand a severe 3 year recession. The authorities conveniently chose not to test any banks from Cyprus, Greece and Portugal as they were all deemed too small to pose a systemic threat. The only failure was Monte dei Paschi, the world's oldest bank, which cobbled together a €5bn recapitalisation shortly before the results were announced. Despite justifiable concerns about the health of the European banking system, anticipating the usual policy fudge, the region's major bourses followed the US higher last month.

Within emerging markets, the Brazilian Bovespa was again the front-runner with an 11% gain. The rebound from the January lows now stands at an impressive 53%. Foreign investors have also benefitted from the rebounding Real amid signs that the economy may be past the worst. Political developments have also helped with President Rousseff's impeachment trial for alleged corruption set to begin on 29th August. On a lighter note, the data provider Factset suggests the recent gains were a pre-cursor to this month's Rio Olympics. With the exception of Sydney and Beijing, every Games since Los Angeles in 1984 has coincided with a rally in the local stock market.

BONDS

There was another sharp fall in UK gilt yields last month (with a commensurate rise in prices), which pushed the 10-year yield to a record low of 0.7%. This was prompted by mounting economic concerns. A "flash" purchasing manager index, commissioned to monitor the initial impact of Brexit, indicated that UK manufacturing and service sector activity contracted last month. Household and business confidence has also slumped. In response, the Bank of England has laid the groundwork for additional support with its Chief Economist, Andy Haldane, calling for the equivalent of a monetary "sledgehammer to crack a nut." With one of Prime Minister May's first acts being to abolish George Osborne's plan to produce a fiscal surplus by 2020, the age of austerity seems to be over, for the time being at least.

The US Treasury market was a little calmer with the 10-year yield finishing flat around 1.5%. It had earlier reached an all-time low of 1.36% before reasonable economic data triggered some profit taking. If you remove the impact of a collapse in energy investment and declining inventories, US

GDP would have been closer to 2% in the second-quarter. In the end it came in at just 1.2% annualised, versus a forecast of 2.6%. With the first quarter also being revised lower to 0.8%, the US economy seems to be struggling.

That said, the labour market appears steady with non-farm payroll hires rebounding to a monthly pace of 287,000 in June (after May's shock figure of 11,000) and wage growth ticking up to 2-3% per annum. Robust housing sales also speak to a fragile economy that is muddling through. Headline consumption expanded at a decent clip of 4% annualised in the second-quarter, but this was flattered by rising rent and healthcare costs. Both are forms of "forced consumption" that reduce other elements of household spending.

The BoJ's failure to match easing expectations caused a mini-riot in the JGB market at the end of the month. The 10-year yield has been in negative territory since February and reached a low of -0.3% in late July. However, the Central Bank's plan to increase equity, rather than debt, purchases was not welcomed by bond markets. Nor was the news that the BoJ will reassess its negative interest rate policy at its September meeting. The 10-year JGB yield has since spiked back up towards 0%, resulting in a capital loss of 2%.

CURRENCIES

A weak finish to the month caused the trade-weighted dollar to fall by almost 1% in July. Despite declaring that "near-term risks to the economic outlook had diminished," the Fed's post meeting statement was generally dovish and suggests a rate rise this year is unlikely.

The Japanese Yen was the most volatile currency, trading between ¥100 and ¥107 intra-month. The initial expectation that the BoJ would act aggressively to weaken the Yen proved ill-judged and the currency rebounded strongly on the Central Bank's limited action. It finished the month 1% higher at ¥102. Conversely, the pound steadied after the initial Brexit shock, but continues to trade around a multi-decade low. It ended July at U$1.32 and whilst we have probably seen the worst of the falls, sterling remains vulnerable if the UK economic downturn deepens.

The Aussie dollar was amongst the lead performers with a 2% gain. It rallied despite calls for the Central Bank to cut rates further. In early August, RBA Governor, Glenn Stevens, duly obliged with a 0.25% reduction in the base rate. This will be one of his final acts after a decade in charge and means he departs next month with the cost of borrowing at a record low of 1.5%. Emerging market (EM) currencies also maintained their run of good form last month with the exception of the Turkish Lira. The military's failed coup sparked a 4% slump in the Lira, but encouragingly there were no signs of contagion to other EM currencies. President Erdogan has since moved swiftly to enfeeble opposition, dismissing over 66,000 public sector workers and detaining more than 10,000 soldiers. The EM debt and currency managers we monitor are understandably eschewing Turkish assets in favour of Latin America and select Asian markets.

GOLD/COMMODITIES

There was a significant unwind of the oil price rebound last month with WTI falling 15% to U$42/barrel. Since the month end it is back below U$40. The main catalyst was the supply side, specifically increased US production. Stocks at Cushing, the delivery point for the WTI contract, rose by 1.1mn barrels (to 65.2mn) last month, reflecting an upturn in US rig activity. The latter highlights the shale industry's technological advances, making production economically viable at ever lower crude price levels. The Baker Hughes rig count began rising in early June as oil hit U$50/barrel.

Bullion added 2% in July, finishing at U$1,351/oz. It has gained 27% so far this year in dollar terms and 38% when measured in sterling. It softened for most of the month until the Fed's dovish rhetoric and the poor US GDP print sparked a rebound. We used the pullback to raise the target allocation in Growth mandates. As we note earlier, weak economic growth will prompt further fiscal and monetary steps, raising concerns about future inflation and fiat money debasement; both support gold's allure. We are mindful, however, that speculative non-commercial positions have moved into overbought territory, which may foster higher price volatility in the near-term.

Industrial metal prices generally firmed last month as China's Q2 GDP came in at a better than expected 6.7% year-on-year. This was driven by the "old economy" as the authorities' fiscal support boosted property construction. The latter represented roughly a quarter of GDP growth, but is a short term panacea that does little to alleviate the country's mounting debt problems.

Conversely, soft commodities weakened in July as grain markets remained over-supplied. The corn price fell 7% on the USDA's announcement that US farmers have seeded 94.1mn acres, an annual increase of 7% and the fourth highest on record.

NEWS & VIEWS

UK Property Funds

The Brexit vote led to the markdown and temporary suspension of several UK property funds. These vehicles invest in commercial property across retail, office and industrial sectors. Following the vote, funds were faced with a flood of investor outflows worth hundreds of millions of pounds. In response, managers suspended dealing and marked down prices by as much as 17% (source: Aberdeen, 6th July).

At one stage, a combined £15bn worth of such "bricks and mortars" property funds were suspended. Some managers were forced to sell assets at fire sale prices in order to meet requests for cash. It was reported that Aberdeen accepted a 15% price cut to sell one property to meet redemptions (source: Bloomberg), whilst Henderson announced plans to sell 440 Strand, the HQ of Coutts, by the end of 2016 (source: FT).

Although some funds have since re-opened and written back part of the losses, several funds remain seriously underwater this year. Funds managed by Aberdeen, F&C, Kames, M&G and Standard Life have lost at least 12% this year (source: Bloomberg). This is a healthy reminder that illiquid assets should not be held in liquid fund structures. It really is that simple.

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

MARKET PERFORMANCE

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

	31-JUL-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3230	-0.6%	-9.5%	-15.3%
CHF	1.0315	+0.7%	-1.0%	-0.3%
AUD	0.7596	+1.9%	-0.1%	+3.9%
JPY	102.06	+1.1%	+4.2%	+21.4%
EUR	1.1174	+0.6%	-2.4%	+1.7%
BOND YIELDS (10 yr)				
UK	0.68	-0.18	-0.91	-1.20
US	1.45	-0.02	-0.38	-0.73
Germany	-0.12	+0.01	-0.39	-0.76
Australia	1.87	-0.11	-0.64	-0.88
Japan	-0.20	+0.03	-0.11	-0.60
EQUITIES				
US. S&P 500 (USD)	2,173.60	+3.6%	+5.2%	+3.3%
UK. FTSE 100 (GBP)	6,724.43	+3.4%	+7.7%	+0.4%
MSCI Europe ex UK (EUR)	1,136.70	+4.1%	+0.3%	-12.7%
Japan. Topix (JPY)	1,322.74	+6.2%	-1.3%	-20.3%
China. Shanghai Comp (RMB)	2,979.34	+1.7%	+1.4%	-18.7%
HK. Hang Seng (HKD)	21,891.37	+5.3%	+3.9%	-11.1%
Australia. All Ords (AUD)	5643.96	+6.3%	+6.2%	-0.7%
MSCI Pacific ex Japan (USD)	1213.73	+6.9%	+4.4%	-3.2%
MSCI World (USD)	1721.79	+4.1%	+3.1%	-2.5%
MSCI World (GBP)	1,301.62	+4.5%	+13.9%	+15.2%
COMMODITIES				
Oil (WTI)	41.60	-15.1%	-12.4%	-22.2%
Gold	1,351.00	+2.2%	+4.5%	+23.3%

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Published and distributed in UK by **Bentley Reid & Co (UK) Limited**
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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**
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