BENTLEY REID

INVESTMENT VIEWS

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EQUITIES	:	Markets rise on US rate bets as earnings continue their slide
BONDS	:	A "hawkish" Yellen hits treasuries as Carney restarts UK QE
CURRENCIES	:	A firm US dollar as the rand resumes its slide
COMMODITIES	:	Early crude oil strength dissipates as gold takes a breather

US productivity is in a funk. Second quarter output per worker fell 0.4% (year on year), the third consecutive quarterly decline, whilst the labour cost of producing each unit of output rose 4.3% (annualised). With unemployment at less than 5% of the work force, companies are having to pay workers more to produce less.

As we have written many times since the financial crisis, companies have failed to invest. They have squandered eight years of QE support, borrowing cheaply to fund share buybacks and generous dividends. Indeed, the binge continues with US companies buying $166bn of their own stock in the first quarter, a 15% rise over the prior 12 months. Company directors have been rewarded handsomely due to the short term fillip this provides to share prices. Shareholders are being left to pick up the pieces, as underinvestment leaves aged capital stock and efficiency slumps; the slump in productivity reflects this reality. Sadly, workers will fare no better, as companies shed labour in an effort to protect profits.

With the Federal Reserve increasingly likely to delay the next US rate rise, this unproductive game of leveraging the balance sheet to make payments to shareholders could continue a while longer; the new highs from the US stock market suggest many still believe in the power of cheap money. Whilst we acknowledge that momentum could support equity markets in the near term, we believe burgeoning indebtedness will curtail current behaviour as companies approach "peak gearing".

Since 2007, US corporate net debt has risen $1.5 trillion, to $3.39 trillion. What is more, if you remove the most cash rich 1% of companies (think Apple, Microsoft, Google and the like), gearing balloons. The remaining 99% actually saw their net debt rise to more than $5.7 trillion (*source: The Absolute Return letter*). For dividends, in the US, the amount of profits paid out to shareholders has just hit a 10 year high. In the UK, dividends now exceed net profits for FTSE companies. Both trends seem unsustainable.

This is already having an impact. US employers are reacting to higher wages by reducing shifts; August saw growth of hours worked slip to 1%, year on year, down from 2.5% in 2015. Record margins are also under pressure. Having peaked at over 10.5%, trailing operating profit margins for the S&P500 fell back to 10.2% by the end of June. With revenues flat lining, profits have fallen. Last quarters' 3.2% contraction in US earnings was the fifth in a row.

Despite all of the above, many market analysts and investors remain optimistic. After expanding at a 1% annualised rate in the first half year, they expect US growth to pick up to 3%, with company fortunes following suit. Fourth quarter S&P500 earnings are expected to rise by 6% (year on year) with 2017 seeing 13% growth. It is a similar picture in the UK and Europe. Should this come to pass and interest rates remain anchored at current levels, this would go some way to validating the recent equity market rise. "Goldilocks" growth (not too hot, not too cold) would banish the bears….

Unsurprisingly to regular readers, we take a more sanguine view. The level of corporate and government indebtedness speak to slower growth, not an acceleration, with profits remaining under pressure; this is doubly so if dollar base rates start to rise, crippling the indebted with higher servicing costs. Even if rate rises are delayed, the efficacy of yet more cheap money is collapsing as companies max out their borrowing capacity and a deflationary mindset pervades.

We suspect that developed nation growth and earnings will disappoint many in the second half of this year, creating a headwind for local equity indices. US rates will remain lower for longer, encouraging the current vogue for emerging market yield plays (specifically equities and local currency debt). We have not been immune to this sentiment, buying modest exposure to oversold Latin American equity markets earlier this year. However, though many developing nation currencies are inexpensive and certain sectors and regions offer pockets of value, many of our preferred, high quality assets are not cheap. Asian consumer stocks, for example, are valued as richly as many of their developed market counterparts. Though nominal yields look alluring, if US, EU and Chinese growth continues to slow, we doubt that developing nations will decouple.

IN OTHER NEWS…

As the Rio Olympics drew to a close, Great Britain could reflect on its most successful games ever. Its haul of 27 gold medals left it second only to the US and one ahead of China. It also equalled the tally of Germany and France combined. As ever, the TV commentators provided a few gems, some of which we share below.

Boxing: "Sure there have been some injuries, and even some deaths, but none of them really that serious"
Basketball: "He dribbles a lot and opposition doesn't like it. In fact you can see it all over their faces".
Rowing: "Ah, isn't that nice? The wife of the IOC President is hugging the cox of the British crew".
And finally in tennis: "One of the reasons Andy is playing so well is that, before the final round, his wife takes out his balls and kisses them…..oh my god, what have I just said?!"

EQUITIES

Equity markets continued to grind higher during the summer months, disproving the old adage "sell in May and go away". Attention focused on the annual gathering of Central Bankers at Jackson Hole, Wyoming. The meeting has taken place each year since 1978. It moved to Jackson Hole in 1982 to help persuade the then Fed Chairman Paul Volcker, who was an avid fly-fisherman, to attend. At this year's conference Janet Yellen offered a balanced if rather hawkish assessment: "In light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months".

The large cap S&P 500 index fell by 0.1% this month whilst the S&P Small Cap 600 index rose by 1.2%. Financial stocks performed well as the market priced in a greater probability of a rate rise in September. We think this unlikely given the pending US election in November and an absence of inflationary pressures. Indeed, economic data remains mixed. The most recent ISM index of manufacturing activity made bleak reading. It fell to 49.4 from 52.6 in July; a reading below 50 signals contraction. In company news, the European Commission ruled that Apple owed Ireland €13bn in back taxes plus interest. Ireland was accused of providing a "sweet heart" deal, enabling the company to pay an effective tax rate of less than 1%. Apple noted it had done nothing illegal despite the talk of unfair competition and state aid. In an unusual situation, the cash-strapped Irish government was quick to declare itself on the side of Apple as it sought to defend its pro-business tax code. Apple CEO Tim Cook did not hide his feeling, describing the decision as "total political crap".

UK stock markets performed well in August, led by mid and small cap stocks. The FTSE 100 rose 0.8% whilst the FTSE 250 and Small cap indexes were both up 2.6%; the latter have now completed a full post-Brexit recovery. Economic data in the UK was generally positive set against low expectations. UK retail sales rose 1.4% in July spurred by a weaker pound, tourist spending and warmer weather. European markets also made gains. The Eurostoxx 50 index gained 1.1% this month. The German market led the way with a gain of 2.5% for the Dax index.

Japan's Nikkei gained 1.9% during August, aided by a weaker yen. Bank of Japan governor Kuroda said that the central bank had "ample space" to ease monetary policy and extend negative interest rates as it attempts to achieve its 2% inflation target. Further monetary support looks inevitable; consumer prices in Japan fell for a fifth month in a row in July, dropping 0.5%.

In Latin America, Brazilian President Dilma Rousseff was finally ousted from office. The Brazilian Senate voted 61-20 in favour of her impeachment. Rousseff described the move as a political coup and "one of history's greatest injustices". Nine members of the Senate were former ministers in her government; six of them voted against her. Former Vice President Michel Temer will make his debut as President on the world stage at the G20 meeting in Hangzhou, China. Signs of political change have swamped concerns about the sharp, ongoing recession; the Brazilian market has been one of the strongest performing markets this year, with a firmer currency boosting returns for foreigners. We remain constructive on the region given the political landscape which is moving in a more market-friendly direction. In Columbia, the government announced a ceasefire with FARC rebels, ending a 50 year war that has left over 200,000 dead. The terms of the ceasefire will be put to the Columbian people in a vote on 2nd October. A successful vote could lay the foundations for important and much needed fiscal reform. Even Donald Trump's visit to Mexico could not dampen the generally positive mood. The MSCI Latin America index rose 1.4% in GBP terms over the month.

BONDS

The Bank of England halved interest rates to a record-low of 0.25% in reaction to Britain's vote to leave the European Union. Governor Mark Carney also announced a plan to buy as much as £60bn of gilts plus an additional £10bn of corporate bonds. Gilt prices surged in response. However, the bank has encountered some difficulty sourcing paper in the market. During the first buyback the bank suffered a £52m shortfall. It seems pension funds and insurance companies are unwilling to part with their bonds, given the dearth of alternatives. The yield on 10 year gilts tightened from 0.68% to 0.64%, whilst 5 year bond yields moved in from 0.28% to 0.21%. Sterling credit spreads have also tightened after a sell-off in the aftermath of the EU referendum. Corporate bond yields fell 1% last month, reducing the spread over gilts by 0.7% (*source: TwentyFour, Bloomberg*). Thankfully, Mr Carney ruled out the prospect of negative interest rates in the UK.

US Treasury yields moved in the opposite direction given Janet Yellen's hawkish tone. The US economy added more than expected jobs in July whilst headline US unemployment held steady at 4.9%. Hourly wages also moved higher at an annualised pace of 2.6%. The yield on 10 year treasury bonds rose from 1.45% to 1.58%, whilst 5 year paper rose from 1.0% to 1.2%.

A vast swathe of Japanese and German bonds remain anchored in negative yield territory. Although bond yields have started to rise a little in Japan, the 10 year JGB only yields -0.06%; the same as German 10 year bonds. The Bank of Japan is due to complete a "comprehensive assessment" of policy in time for its next board meeting on September 20-21. Whilst one has to expect a reaffirmation of QE, it will be interesting if they acknowledge the limitations of any part of their current policy approach.

The World Bank sold a ground breaking bond backed by the IMF's currency reserve basket in mainland China. The 3 year bond will pay an annual yield of 0.49% and will be denominated in the SDR (Special Drawing Rights) currency which is backed by a mixture of the US dollar, euro, yen and sterling and will soon include the Chinese yuan. The first tranche of $700m was soon snapped up and set the stage for further issues.

CURRENCIES

The trade weighted dollar index rose 0.5% during August, as Yellen's Jackson Hole speech encouraged markets to price in a 15% chance of two rate rises before the year end (compared to 0% at the start of July). Most major currencies weakened against the dollar including the pound, yen and euro to varying degrees. The Swiss franc was a rare exception as it appreciated 1.5% versus the dollar. Emerging currencies in general fared well with the notable exception of the rand.

The British pound fell by 0.7% against the dollar this month and briefly traded below $1.30. It finished the month trading at $1.31. Positive data on UK retail sales (see above) and a strong rebound in UK manufacturing activity as a result of GBP weakness helped to put a floor under sterling. The Markit/CIPs PMI rose to 53.3 in August from 48.3 in July. This was the biggest month on month increase in 25 years. The contraction in Britain's building industry also moderated in August, but failed to match the rebound in manufacturing activity.

The yen weakened by 1.3% this month. Having recently tested the psychologically important rate of ¥100 against the dollar, the currency finished the month at ¥103. Both manufacturing and services leading indicators have been below 50 in recent months which reflect a stagnant private sector. Business sentiment has slumped, with capital spending growing at its slowest pace since 2014. If the policy makers do not pull a rabbit out of the hat soon, Japanese equity, bond and currency markets could attract unwanted bearish speculation.

The Euro was broadly flat against the dollar, weakening by just 0.1% this month. Economic growth remains unimpressive across the region with Germany the relative bright spot. Inflation remains subdued at 0.2%, unchanged from the previous month. The Italian banking system remains undercapitalised, despite the usual policy fudge; risks look skewed to the downside.

The Chinese yuan depreciated by 0.6% versus the US dollar. Over the last 12 months China has had to increase credit in the system by 25% to hold growth rates flat. The credit to GDP ratio has fallen to a record low of nearly 6 to 1. Overall Chinese business activity saw a modest slowdown, though the rate of expansion was the weakest in four months. On one side, service companies reported the strongest expansion in a year. On the other, manufacturing output declined at its sharpest pace since February. As the impact of aggressive credit growth in the first half wanes, we suspect the growing imbalances will become more and more apparent.

Turning to emerging markets, the rise in the oil price helped the currencies of commodity exporting countries such as Russia and Brazil. The rouble gained 0.9% whilst the real gained 0.7%. In contrast, the South African rand was one of the worst performing currencies this month; it fell by 6.1%. Finance minister Pravin Gordhan is under investigation about his tenure as head of the South African tax authority, whilst the ANC remains under pressure at the ballot box.

GOLD/COMMODITIES

Gold has been a strong source of return this year with the precious metal up 23% in 2016 in USD terms. This month saw the price slip 3.1% from $1,351 to $1,309. Investors took profits on long positions as the Fed talked up the possibility of rate hikes this year. We continue to see gold as a valuable hedge against the currency debasement inherent in QE and the risk of an eventual inflation blowout.

Oil markets rallied this month on speculation that the OPEC cartel could re-introduce production quotas at their informal meeting in Algeria in September. US WTI and European Brent both rose by 6%. WTI finished the month at $45 with Brent at $47.

Iraq, the second largest oil producer in OPEC, indicated that it was looking for a production cap although it did not formally commit to the move. Saudi Arabia remains key to any new agreement, but has shown little appetite in advance of the blockbuster IPO of Saudi Aramco. OPEC crude oil production was 33.4m barrels per day (bpd) in July; an eight-year high. Saudi Arabia's oil production hit record levels in July as it pumped 10.67m bpd, exceeding the prior record of 10.56m bpd. Though some of this was for domestic consumption, as record temperatures triggered an upswing in air-conditioning demand, there are no signs of OPEC supply moderation. Indeed, troubled areas like Nigeria have also showed improved supply metrics. Similarly, non-OPEC supply rebounded with the return of Canadian production following recent wildfires.

Towards the end of the month oil once again sold off as US crude inventories rose by 2.3m barrels; much higher than expected. Overall, upside for the oil price seems constrained in the near term unless the Saudis change tack. The longer term supply/demand picture remains nuanced as ever more efficient US shale oil extraction is offset by the lowest level of reserve discovery since 1947 (*source: Wood Mackenzie)*. Oil discoveries in 2015 were 10% of their 50 year average.

Agricultural commodities prices were weak again this month. As we have discussed in previous months, inventories have risen to elevated levels following three bumper years for wheat, corn and soybean crops. Wheat prices hit a decade low of $3.83 per bushel as the International Grains Council increased its global production forecast to a record 743m tonnes. Wheat prices were down 11% this month. Anecdotal evidence suggests merchants who have run out of storage in silos are piling wheat outdoors.

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-AUG-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3138	-0.7%	-9.3%	-14.4%
CHF	1.0164	-1.5%	+1.0%	-1.7%
AUD	0.7517	-1.0%	+3.9%	+5.7%
JPY	103.43	-1.3%	+7.1%	+17.2%
EUR	1.1158	-0.1%	+0.2%	-0.5%
BOND YIELDS (10 yr)				
UK	0.64	-0.04	-0.79	-1.32
US	1.58	+0.13	-0.27	-0.64
Germany	-0.07	+0.06	-0.20	-0.86
Australia	1.82	-0.05	-0.48	-0.84
Japan	-0.07	+0.12	+0.05	-0.45
EQUITIES				
US. S&P 500 (USD)	2,170.95	-0.1%	+3.5%	+10.1%
UK. FTSE 100 (GBP)	6,781.51	+0.8%	+8.8%	+8.5%
MSCI Europe ex UK (EUR)	1,147.39	+0.9%	-0.3%	-4.4%
Japan. Topix (JPY)	1,329.54	+0.5%	-3.6%	-13.5%
China. Shanghai Comp (RMB)	3,085.49	+3.6%	+5.8%	-3.8%
HK. Hang Seng (HKD)	22,976.88	+5.0%	+10.4%	+6.0%
Australia. All Ords (AUD)	5,529.41	-2.0%	+1.5%	+5.9%
MSCI Pacific ex Japan (USD)	1,187.29	-2.2%	+5.2%	+8.0%
MSCI World (USD)	1,719.52	-0.1%	+2.7%	+4.5%
MSCI World (GBP)	1,308.52	+0.5%	+13.4%	+22.0%
COMMODITIES				
Oil (WTI)	44.70	+5.6%	-11.1%	-19.0%
Gold	1,308.97	-3.1%	+7.7%	+15.3%

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