BENTLEY REID

INVESTMENT VIEWS

OCTOBER 2016

www.BentleyReid.com

EQUITIES	:	Central Bank doves support market momentum
BONDS	:	Inflation linked bonds outperform as yield stay low
CURRENCIES	:	Bank of Japan efforts fail to weaken the Yen
COMMODITIES	:	OPEC outlines a deal to cap crude production

Central Bank (CB) credibility looks increasingly vulnerable. The last two initiatives from the Bank of Japan (negative interest rates and a zero yield target for 10-year government bonds) have been dismissed by markets; the yen rallied after both announcements. The European Central Bank's March introduction of a -0.4% deposit rate was met with a similar response. If the US Federal Reserve was forced to trigger QE4, would it fare any better?

No matter, the erosion of CB efficacy does not signal the end of cheap money. As one of our Investment Advisory Committee noted, CB's are stuck in the 'Hotel California' of policy; "You can check out anytime you like, but you can never leave!" With their economies delicately balanced between inflation and recession and asset values underpinned by zero-bound rates, developed market CB's are unable to scale back liberal monetary policy. Asset bubbles and contradictions are growing.

As we have consistently stated, we believe the authorities will risk excessive inflation in pursuit of self-sustaining growth; recession could spawn deflation, the bête noire of the over indebted. Monetary policy will thus stay lower for longer than markets expect, as evidenced by the "data dependent", rate procrastination of the Federal Reserve this year.

Given this backdrop, the current fashion for emerging market (EM) assets is understandable. If the new normal is moribund American growth, low US rates will persist. A soft greenback and a flood of return seeking dollars should support EM bonds and equities. Indeed, in a world of chronically over-priced assets, it is possible to find EM opportunities that are cheap on both absolute and relative measures when compared to their developed market peers.

As ever, the EM universe cannot be treated as a homogenous set of countries; China, in particular, is a special case. However many constituents exhibit lower government debt levels; positive demographics; structural growth; rising productivity and the return of current account surpluses.

Given the absence of EM QE, they would also enter any economic slowdown with more monetary and fiscal policy options. As we noted last month, we have not been immune to these long-term arguments; our risk tolerant portfolios have direct exposure to Asia and Latin America, with the latter also evident in our more cautious mandates. So why not have more?

In the near term we continue to believe that the US economy will disappoint. Consensus expectations of a 3%-plus growth rate in the second half of this year looks recrementitious. Though this suggests low US rates and a weaker dollar, we worry that the slowdown may carry a whiff of recession. If that is the case, EM bonds and equities may pause, especially after their performance for the year to date. Our concerns are compounded by several near term events that could amplify any risk-off zeitgeist; "President Trump", the December Italian referendum, Chinese debt indigestion, the travails of EU banks and Greek insolvency are but a few.

Finally, if we are wrong and US growth accelerates, the prospect of US rate rises, even if the pace and magnitude is modest, could drive the dollar higher, undermining EM assets in the short term.

We are thus happy to stay our hand and wait for critical US third quarter economic data points. If these provide a solid backdrop for the inauguration of President Clinton, we may well be adding to our EM assets at higher prices. That said, we expect to have an opportunity to increase exposure to these attractive, long-term themes at lower levels. Patience and ready cash remain the order of the day.

IN OTHER NEWS…

Aged 87, Arnold Palmer passed away on September 21st. From humble origins, "The King" broadened golfs appeal way beyond the elite as he embraced the TV age and all the marketing opportunities that flowed from it. Having turned pro in 1954, he won 62 PGA tour titles, including 7 majors, in a career that spanned 6 decades. Married to Winifred for 45 years until her passing in 1999, Palmer was also an avid pilot, clocking up over 20,000 hours during his lifetime. A few "bon mots" from the golfing legend:

"Golf is deceptively simple and endlessly complicated!"
"Putting is like wisdom – partly a natural gift and partly the accumulation of experience."
"Winning isn't everything but wanting it is."
"It's a funny thing, the more I practice the luckier I get."

EQUITIES

Equity markets responded well to dovish messages from the Federal Reserve and Bank of Japan, helping offset a weak start to September. This completed a strong quarter for share prices despite concerns over deteriorating economic and corporate fundamentals.

Last month saw US rate-setters again resist calls to raise the cost of borrowing. The start of year consensus was for four 0.25% rate increases in 2016, but with three months and two policy meetings to go, we would be surprised to see any change from the current 0.25-0.5% target.

Markets continue to obsess about the Fed's "next step" when in reality a modest rate rise is unlikely to have a major economic impact. However, the number of Committee members advocating an immediate hike rose from one to three (out of 12) last month, suggesting Fed "noise" will remain an outsized influence on short-term market moves. The S&P 500 finished flat over the month and is 6% higher this year.

Governor Kuroda, Bank of Japan (BoJ) chief, has deployed some of the most aggressive Central Bank support of recent years. However, faced with entrenched deflation, waning growth and complaints that negative rates harm their banks health, he was forced to change tack last month.

Going forward, the BoJ will no longer set a defined timeline for achieving its 2% inflation target. Instead, it will keep short-term rates negative, whilst trying to anchor the 10-year JGB yield around 0%. Longer dated JGBs will be less encumbered by CB interference, suggesting that the yield curve could steepen. This sparked a relief rally in bank share prices on the hope it will increase margins on lending activity. However, the non-financial sectors lagged as the Yen (counter intuitively) rose on the news. Market behaviour suggests the BoJ is reaching the limits of its policy efficacy, with reflation efforts looking increasingly desperate. The Topix finished the month 0.5% lower.

European indices were weighed down by renewed weakness in commercial bank shares as uncertainties over non-performing loans and capital shortfalls intensify. Deutsche Bank (DB) is the most acute example of investor angst with its share price slumping to a three decade low last month. Its value has halved over the past year. Despite passing the ECB's summer stress tests, DB has been besieged by wide-ranging concerns including the €40bn of "level 3" derivatives that sit on its balance sheet. These illiquid securities are priced using in-house models rather than being "marked to market"; many analysts believe their true value is materially lower.

News that the Department of Justice may fine DB U$14bn for the mis-selling of US mortgages before the financial crisis compounded its misery; although the final penalty is likely to be lower, the current figure exceeds DB's market capitalisation. More cynical commentators noted that the fine roughly matched the European Commission's earlier demand that Apple pay the Irish government €13bn in back taxes. Most European bourses headed lower in September.

UK indices nudged higher last month, adding to their post-Brexit rebound. In recent weeks the more domestically-focused stocks have caught up with the large-cap multinationals on signs the economy is weathering the storm. The Small Cap index generated a 2% monthly gain and was up 11% over the quarter.

The large-cap FTSE 100 was buoyed by a weak sterling and resource names; both energy and mining stocks benefited from recoveries in the underlying commodity prices, a feature of 2016 to date. Conversely, the more defensive consumer staples sector lagged on the Federal Reserve's message that a rate rise is still possible this year. As we have noted before, these "bond proxy" stocks have been one of the primary beneficiaries of cheap money and may lose their appeal as and when cash and bond yields move higher.

Elsewhere, EM produced a mixed performance. Russia benefited from a late rally in the oil price, borne of OPEC's surprise decision to cut output; the RTS index gained 4% in dollar terms.

Mainland Chinese stocks drifted lower last month, but HK indices performed well. A surge in capital flows boosted the H-share market as speculators took positions ahead of the introduction of the Shenzen/HK Connect program later this year. The scheme broadens mainland access to HK listings and looks set to attract high demand as "onshore" investors seek new methods to export their capital from China.

Finally, Brazil's Bovespa added 1% as ex-President Lula was formally charged for his alleged role in the Petrobas corruption scandal. Unlike his padawan, President Rouseff, who was impeached in August, he remains a popular national figure and the court case will likely add to the country's social tensions. Though unsettling, political change has been a major catalyst for equity investors this year; the Bovespa has so far returned 35%.

BONDS

Sovereign bond markets witnessed a mini "taper tantrum" at the start of the month with yields rising sharply on fears the Federal Reserve would proceed with a rate rise. It reminded us of the abrupt bond sell-off in 2013 when then Fed Chairman, Ben Bernanke, announced a reduction in QE purchases. This time round, bond markets settled after the Fed announced "no change"; such volatility speaks to market fragility. Although US policymakers are in no rush to raise rates, the sense that cheap money is the cause (rather than the cure) of the prevailing economic funk seems to be gaining traction.

In the UK, the 10-year gilt yield initially spiked from 0.6% to 0.9% before retracing half the move; it finished the quarter at 0.75%, close to its all-time low. As expected, there was no change at the MPC's September meeting with the base rate left at 0.25%. In contrast to the US, the doves are in the ascendency with some rate-setters talking up a rate cut before year-end. This would be somewhat at odds with recent economic news flow; the manufacturing and services PMIs moved back into expansionary territory in August with GDP growth forecast to be flat in Q3, despite pre-referendum recession fears.

On that note, it remains too early to judge the impact of Brexit though economic risks seem skewed to the downside given the inherent uncertainty of the next couple of years. Indeed, Prime Minister May's pledge to trigger Article 50 by March 2017 reminded markets that next year is the harbinger of wholesale change.

The impact of a weak sterling is starting to appear in the inflation statistics with the CPI accelerating to +0.6% year-on-year. Judging by the recent outperformance of index-linked gilts, investors expect inflation to rise further. The Debt Management Office took advantage of this strong demand, selling a 36-year index-linked issue at a record low real yield of -1.8% per annum.

Support for inflation-proof bonds is also robust across the Atlantic; the US inflation linked treasury ETF gained 0.6% last month and is 8% higher this year. Although rising healthcare and rental costs have fuelled some US inflation concerns, core CPI has stalled around 2% year-on-year. Absent a more notable rise in wage growth, the bond market continues to price in modest inflation and low US rates. The 10-year Treasury yield fell back to 1.6% last month, despite Chairwoman Yellen's suggestion that a 2016 rate rise was still on the cards.

CURRENCIES

With the exception of sterling, volatility in FX markets has been muted over the summer. This adds weight to the (unsubstantiated) rumours that the G20 leaders struck a deal to stem the dollar's advance during their February 2016 China meeting.

Regardless, with the BoJ QE bond buying policy set to leave it owning half the JGB market by the end of 2017, Governor Kuroda decided not to extend the ¥10-11trn of JGBs per month purchase rate. Instead, he stepped back from a defined timeline to achieve 2% inflation and announced a loose commitment to manage the yield curve. The Yen was unimpressed and added another 2% against the US dollar (to ¥101) last month. The moves left markets increasingly concerned that the BoJ is running out of credible policy options; a view we share.

Unlike his peers in the US and Japan, President Draghi had a quiet summer; the ECB has not eased policy since March when it cut the commercial bank deposit rate to -0.4%. Instead, whilst the ECB assesses the impact of QE to date, Draghi reignited his public spat with the German government. Draghi's plea for greater fiscal spending from member states (ie. Germany) was not well received by Frau Merkel's Finance Minister, Wolfgang Schaeuble. A long term critic of the reflationary policies of the ECB, he encouraged German lawmakers to take a "tough stance" with the ECB head when he appeared before the Bundestag.

The US dollar was little changed last month. It is currently stuck in a trade-off between the prospect of Fed rate rises (a support given the lack of yield available elsewhere) and the possibility of President Trump and/or slower growth. It is hard to make a near term call, given the political dimension.

On a related note, having recovered from multi-year lows during the course of 2016, many EM currencies will likely struggle if "The Donald" wins the election on November 8th. The Mexican Peso has proved to be a barometer of Trump fortunes, given his aggressive anti-Mexico trade rhetoric. Having fallen over 15% this year, the peso rebounded 2% after Trump's poor performance in the first televised debate.

GOLD/COMMODITIES

OPEC's surprise decision to cut production for the first time in 8 years sparked a surge in the oil price in late September; the WTI contract rose 6% on the news, finishing the month 7% higher. At U$48/barrel it is back to its level of a year ago.

The announcement came at the cartel's planned meeting in Algeria, where most had expected the impasse between Saudi Arabia and Iran to persist. The latter has been refusing to curb daily output until it returned to pre-sanction levels of 4 million barrels per day (mbpd), whilst Saudi needs higher prices to help plug a budget deficit that has reached 13% of GDP.

OPEC accounts for 40% of global production and will aim to reduce output to a range of 32.5-33mbpd. The lower bound is 0.75mbpd below current levels, which would help address some of the oversupply that has caused prices to tumble over the past 2 years. However, the detail of which OPEC members bear the brunt of the cuts has yet to be agreed and non-OPEC supply is expanding. In September Russia pumped a post-USSR record of 11.1mbpd as new Siberian oil fields came on stream. Coupled to an uptick in US shale oil production, the OPEC news suggests a new floor under prices, rather than a new bull market for crude oil.

Most industrial metals enjoyed a strong month, buoyed by China's "red hot" property market. Many tier 1 cities are seeing 30% plus annualised price gains, driven by government stimulus measures. The trend seems to be another example of "short-term gain for long-term pain" as the support amplifies an already precarious debt burden. Last month's BIS report on China's borrowing binge made for sober reading; overall credit/GDP reached 255% at the end of 2015, a rise of 100% over 8 years. Total outstanding debts, much of which sits in the property sector, now stand at U$28 trillion.

Gold rallied 0.5% in dollar terms with the Fed's inaction and European banking woes spurring demand. Speaking at a gold mining conference in South Africa, Randgold CEO Mark Bristow declared "the lack of new discoveries, cost-cutting and mines digging out higher grade material for short-term gain…are to blame for a supply side crunch in the industry". Improved fundamentals in the physical market and high investment demand should keep the gold price well bid.

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
+	LATIN AMERICA	INFLATION LINKED	UNCORRELATED STRATEGIES, GOLD
O	UK, AUSTRALIAN, ASIA, 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.

	30-SEP-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2972	-1.3%	-2.5%	-14.3%
CHF	1.0295	+1.3%	+0.5%	+0.2%
AUD	0.7664	+2.0%	+2.9%	+9.2%
JPY	101.35	+2.1%	+1.8.%	+18.3%
EUR	1.1235	+0.7%	+1.2%	+0.5%
BOND YIELDS (10 yr)				
UK	0.75	+0.10	-0.12	-1.02
US	1.60	+0.01	+0.12	-0.44
Germany	-0.12	-0.06	+0.10	-0.71
Australia	1.91	+0.08	-0.07	-0.70
Japan	-0.09	-0.02	+0.13	-0.45
EQUITIES				
US. S&P 500 (USD)	2,168.27	-0.1%	+3.3%	+12.9%
UK. FTSE 100 (GBP)	6,899.33	+1.7%	+6.1%	+13.8%
MSCI Europe ex UK (EUR)	1,144.67	-0.2%	+4.9%	-0.2%
Japan. Topix (JPY)	1,322.78	-0.5%	+6.2%	-6.3%
China. Shanghai Comp (RMB)	3,004.70	-2.6%	+2.6%	-1.6%
HK. Hang Seng (HKD)	23,297.15	+1.4%	+12.0%	+11.8%
Australia. All Ords (AUD)	5,525.15	-0.1%	+4.0%	+9.2%
MSCI Pacific ex Japan (USD)	1,214.23	+2.3%	+7.0%	+15.3%
MSCI World (USD)	1,725.67	+0.4%	+4.4%	+9.1%
MSCI World (GBP)	1,330.51	+1.7%	+6.8%	+27.3%
COMMODITIES				
Oil (WTI)	48.24	+6.5%	-3.8%	-4.2%
Gold	1,315.75	+0.5%	-0.5%	+18.0%

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

The content of this document is for information purposes only. The authors believe that, at the time of publication, the views expressed and opinions given are correct but cannot guarantee this and readers intending to take action based upon the content of this document should first consult with the professional who advises them on their financial affairs. Neither the publisher nor any of its subsidiaries or connected parties accepts responsibility of any direct or indirect or consequential loss suffered by a reader or any related person as a result of any action taken, or not taken in reliance upon the content of this document.