BENTLEY REID

INVESTMENT VIEWS

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EQUITIES	The S&P500 slides on election nerves as the Nikkei enjoys a soft Yen
BONDS	Inflation uptick pushes global yields higher
CURRENCIES	The US dollar rises on rate speculation and "President Hillary"
COMMODITIES	Chinese growth underpins metals as oil slides on OPEC infighting

After a prolonged period of strong demand, September US auto sales fell 0.5%, year on year. The pause came despite record incentives, from manufacturers to dealers, of $3,888 per car. Demand has been financed by the aggressive provision of debt. New auto loans now have a record average maturity of 66 months, with 31% of all new cars financed by debt with repayment periods of 73-84 months (another record). If one also considers that 23% of the $1trn of outstanding auto debt is held by sub-prime borrowers, one has to wonder about loan quality and sustainability of demand.

Why dwell on such economic minutiae? The consumer is vital to US growth and, with the housing market and retail sales showing signs of fatigue, the detail suggests that US growth is fragile. Indeed, though third quarter GDP growth came in at 2.9%, as we note later, 0.9% of this was accounted for by a one off surge in soya bean exports (source: *Pantheon Macroeconomics*). The underlying reality is that the US economy is expanding at a 1.5-2% rate and remains reliant on Central Bank support and low energy prices.

The same basic fact is true of most large nations. Despite the desperate interventions of global Central Banks, growth is either absent (Japan), stubbornly sub-par (US & Europe) or slowing (China & Asia); ASEAN nations expanded at 4.4% in the twelve months to end September, the slowest rate in over a year. At the global level, it is not only the Central Banks that count; China has played a vital role in propping up the world economy.

Faced with a precipitous slowdown at the end of 2015, the Chinese authorities injected vast amounts of debt into the domestic economy to avoid the risk of a nasty debt default cycle. To put figures on it, debt in China has risen by U$4.5trn over the last 12 months, more than the US, Japan and the Euro Area combined (source: *Morgan Stanley*, *Zerohedge*). Though this staved off a rapid contraction, a lot of the debt has simply (re)fuelled unproductive investment and property prices. Commodities have recovered, with iron ore and thermal coal prices rising by over 75% from their recent lows.

The impact of debt fuelled Chinese demand, recovering commodity prices and tight US labour markets is prompting an uptick in inflation across the globe, admittedly from low levels. Whether this is sustained or merely peters out remains a key question for markets and policy makers.

As China attempts to control its debt incontinence and a property price bubble, growth should moderate; indeed, with over-investment and excess capacity still self-evident, deflationary pressures could easily reappear on the Mainland. For now, we doubt that China will lose control of its domestic reality, not least because President Xi cannot afford an unruly economy as he seeks to consolidate power at the Autumn 2017 National Congress. No matter, with growth set to slow and the renminbi on the slide, Chinese demand for commodities and imports should wane.

To us this means that, whether US rates rise in December or not, global growth will remain challenged. It also suggests that, absent an exogenous shock, the current uptick in inflation could well prove transitory (though the risk of cost push inflation cannot be ruled out). Put simply, global growth will continue to fall short of a rate that enables economic players to maintain and retire accumulated debts, suggesting debt metrics will continue to deteriorate.

At some stage, we will have to settle the bill; the debts will eventually become unsustainable. At that point, we could see mass debt defaults and a nasty recession, clearing out unproductive loans and capacity; painful but cathartic. More likely, as we have often noted, we sense that authorities will do all they can to engineer inflation, as this is a more acceptable way to retire debt. Whether this episode is preceded by a deflation scare and whether they can control the subsequent inflation hydra, is a moot point for the future.

As such, we continue to try and grind out acceptable nominal returns without placing too much capital at risk. We remain defensive, favouring a limited number of high conviction exposures and elevated cash levels. With a busy political calendar further clouding the outlook, we see no need, as yet, to be brave.

IN OTHER NEWS…

On the 7th October, sterling slumped to an intra-day low of $1.1841; this was its lowest level since 1985. Since then, the average UK house price has risen over 640% (from £34,174), whilst the cost of a pint of milk has nearly quadrupled from 23p.

In the movie world, Michael J Fox had his breakout role in "Back to the Future", whilst Roger Moore gave his last appearance as James Bond in "A View to a Kill". Tears for Fears had the best-selling single with "Everyone wants to rule the world"; Everton won the league.

In other football news, Hong Kong beat China 2-1 on the 19th of May, ending the Mainlanders hopes of qualifying for the Mexico '86 World Cup. The PLA had to supress riots in Beijing whilst the victors arrived at Kai Tak airport to a hero's welcome!

EQUITIES

By the end of October, markets had priced in a Democratic election triumph. With risk assets favouring Clinton's putative coronation, should November 9th herald the dawn of President Trump, market volatility will surely surge. Though the precise impact of a Trump administration is hard to divine, panic selling might well throw up opportunities; we have a shopping list of assets we would like to buy.

The S&P 500 index edged 2% lower last month, with returns dominated by a handful of large cap tech names. The US mid and small caps fared worse; the Russell 2000 index fell by almost 5%. At 2.9% annualised, third quarter GDP surpassed modest expectations, though the headline masked deteriorating domestic momentum. The all-important consumer sector expanded by just 2% with households struggling to spend in the face of rising housing and healthcare costs. For many, "Obamacare" health insurance premiums are rising by over 20% year-on-year.

The latest profits season reflects a US (and global) economy that is struggling to attain self-sustained momentum. Aggregate earnings of S&P 500 listings are set to grow by just 2% in the year to end September; a meagre pace, but the first positive figure for 6 quarters.

The financial sector was the largest contributor with 8% growth, led by a surge in fixed income trading at the investment banks. Only time will tell if this was a one-off fillip borne of record bond issuance or the start of a more sustainable trend; we suspect the former.

Conversely, the "expensive defensive" sectors struggled as rising bond yields made these yield proxies less attractive. Utilities, consumer staples and telecoms have all started to underperform. The healthcare sector also lagged, as biotech names dragged the sector 7% lower. This comes despite solid sales and profits for the past 12 months. Hillary Clinton's (and California's) pledge to clamp down on egregious drug pricing has knocked sentiment, whilst some high profile clinical trials have failed to deliver.

The energy sector was one of the few to post a third quarter earnings contraction as profits shrank by 65%. This had already been largely discounted by markets; the MSCI Energy sector slipped 2% over the month. Energy firms are forecast to grow earnings by more than 300% next year, rebounding from a low base. This, in turn, is a key prop for the 12% earnings expansion forecast for the US market as a whole. With growth in the doldrums and crude prices range bound, such projections seem a tad optimistic to us.

Beyond the US, it was a healthier month for equity markets. In the UK, the FTSE 100 added 1%, aided by renewed falls in sterling. Up to 80% of large company earnings now originate from overseas so the 16% tumble in the trade weighted pound since Brexit has been a boon for the sterling value of overseas profits.

The more domestically focused FTSE 250 lagged with a 2% loss on a number of post-Referendum profit warnings. Overseas travel operators have been hit hard by the soft pound whilst property and retail sectors are troubled by waning consumer confidence. Rising input costs, borne of firmer wages and higher import prices, are also pressuring margins.

European indices have also benefited from a weaker local currency, with most local bourses adding at least 2% last month. This came despite a torrid earnings season for European firms; Stoxx 600 profits fell 13% in the 12 months to end September (source: Thomson Reuters). This reflects weak, uneven EU growth and entrenched disinflation; despite ongoing Central Bank support, GDP expanded by just 0.3% over the third quarter. Political risks also loom large with opinion polls suggesting Prime Minister Renzi will narrowly lose December's referendum on Italian constitutional reform. Viewed by many as a plebiscite on EU membership, Renzi has threatened to resign if he loses. This would reignite debate on the future of the EU, a troubled backdrop for 2017 elections in France and Germany

Turning east, Japanese stocks continued their recovery with the Topix advancing 5% in October, despite further evidence of deflationary stagnation. Yen weakness boosted the exporters with the currency falling 3% to a 3 month low of ¥105. The financial sector was also a strong performer as the Bank of Japan avoided pushing rates further into negative territory and announced efforts to try and steepen the government yield curve. Both measures can help bank profitability.

In China, the Shanghai Composite rose 3%, as headline growth benefitted from the delayed impact of late 2015 stimulus. Though we do not under estimate the ability of the Chinese to manage their domestic reality, growth looks increasingly vulnerable as the Yuan slides and the authorities look to address rampant credit growth, rising bad debts and a property bubble.

Finally, after consolidating for two months, Brazil's Bovespa surged 11% in October. A 30% gain in Petrobras, the semi-public energy behemoth and a dominant part of the index, led the advance. The market has been one of this year's stellar performers with a 50% gain, despite downbeat economic data. The central government deficit rose to BRL25bn in September as tax revenues slumped by 8% over the year. Most activity indicators are becoming "less bad," but the Brazilian economy remains troubled. As such, our Latin America fund exposure remains the one truly risk tolerant holding inside an otherwise low risk equity allocation.

BONDS

The rise in global bond yields continued last month. With oil and metal prices rallying sharply from their 2015/16 lows, near term inflation pressures are starting to build. Whilst nominal price levels are not elevated, year on year comparisons are now turning positive; the trend poses a threat to overvalued bond markets.

UK gilts sold off sharply last month; September inflation came in at 1%, a 2-year high. Higher prices seem inevitable next year as sterling's slump raises import costs. Last month's "Marmite war" highlighted the trend as Unilever temporarily halted deliveries of the spread to Tesco online; the retailer had initially refused to accept a weak sterling-induced price rise. The matter was swiftly resolved but, as manufacturers hedges expire and inventories get drawn down, UK prices will rise.

Gilts were also undermined by Prime Minister May's dontopedalogy, as she openly questioned Bank of England policy. During her speech at the Conservative Party conference she claimed that QE had created "bad side effects" and called for change.

Though we have sympathy with her argument that the prolonged provision of cheap money has contributed to social inequality and economic stagnation, any suggestion that the Bank's independence is being questioned sounds alarm bells. With global investors gingerly assessing the stability of post-Brexit UK, any sign that the Central Bank is under siege could drive bond yields higher and trigger a recessionary wave of debt defaults. The Prime Minister has since backtracked, but the 10-year gilt yield had risen above 1.2% by month-end, more than double its August low. We sold the last of our straight Gilts for mixed asset mandates early in the month; nominal yields remain vulnerable at these levels.

US Treasury yields also rose last month despite mounting concerns over US GDP. Though Q3 annualised growth of 2.9% was the fastest for 2 years, it was driven by the transitory effects of rising inventories and a surge in food exports. The latter meant net trade accounted for about 1/3rd of growth, which in turn was dominated by soybean exports. A poor harvest in South America left the US as one of the few suppliers that could satisfy global demand. The 10-year US Treasury finished the month 0.2% higher at 1.8%.

The bond sell-off spread to Europe and Japan even though their deflationary narrative remains intact. Eurozone core inflation remains below 1% and recent ECB chatter has reverted to how it can extend QE when the current program expires next March. Eurozone yields should remain depressed. In Japan, the general price level continues to fall despite “Abenomics” reflation efforts. Headline and core CPI fell 0.5% year-on-year in September; we struggle to see what reverses this trend.

CURRENCIES

Sterling was the worst performing major currency in October. It fell precipitously (again) from U$1.30 to a mid-month low of U$1.21 as speeches at the Tory Party conference inferred a “Hard Brexit” outcome. We view current rhetoric as political positioning and expect pragmatic engagement after the German election next autumn.

It is still several months before Article 50 is scheduled to be invoked, but trade discussions are already taking place on the home front. Car maker Nissan has committed to building two new models at its Sunderland site, having received assurances that the UK government will strive to secure tariff free access to EU markets. Britain seems to have a credible hand in negotiations over trade in goods, given the sizeable deficit it runs with mainland Europe; it will be tougher to find common ground over the City and financial services, given the jealous eye cast by Paris and Frankfurt.

Elsewhere it was a case of general US dollar strength. The trade-weighted greenback added 3% as investors priced in the high probability of a December US rate rise and a Clinton win.

Regardless of what the US Fed does between now and year end, financial conditions are already tightening. A shortage of dollars across large parts of the global financial system has led to a sharp rise in short-term borrowing costs. The Bank for International Settlements estimates higher dollar LIBOR costs will promptly feed through to U$5trn worth of bank loans. Indeed, Goldman Sachs estimates that up to 30% of US business loans and 20% of mortgages and student loans are priced off three month LIBOR. This rate has nearly tripled this year to 0.9% and will act as a drag on growth as we head into 2017.

In China, even though manufacturing activity is rising at the fastest rate since March 2011, the renminbi continues to slide; it lost 2% in October (versus the dollar) to hit a multi-year low of Rmb6.8. Although official FX reserves have stabilised around U$3.2trn, capital continues to leave the country via foreign direct investment and other less obvious channels; the recent ban of Mainlanders using their Union Pay cards to buy dollar denominated, HK based insurance products closed down one opportunity. Interestingly, as China manufacturing enjoys the transitory sugar rush of past stimulus, activity at Asian competitors has waned; the competitive pressure of cheap renminbi exports is hard to avoid.

GOLD/COMMODITIES

Hard metals extended their advance last month, driven by resilient Chinese industrial data and the prospect of a global fiscal boost. Both US Presidential candidates have promised to increase infrastructure spending and the UK government is poised to follow suit. Even Eurozone leaders are talking up "pro-growth" policies in spite of Germany's restraint. Iron ore was one of the main winners with a 7% gain.

In crude markets, the OPEC deal to cut output still lacks detail. A stalemate has been caused by Iran and Iraq, who both want exemptions from the curb. The cartel's attempt at unity is also threatened by news that many of the US shale producers have hedged their production at U$50 per barrel. This means a fall in the oil price won't necessarily dent their profits, forcing OPEC to adhere to steeper production cuts if price stability is to be achieved. Other non-OPEC nations are also unlikely to support the cuts. Despite talk of cooperation, Russia continues to pump at a post-USSR record, whilst Brazil has publically refused to curtail supply. Given the impasse, stockpiles remain elevated and the WTI oil price fell by 4% to U$47/barrel last month.

The gold price drifted 3% lower to U$1,274/oz. The rise in yields on defensive assets has created a headwind, as has the unwinding of speculative long positions. CFTC net long non-commercial holdings, a reliable barometer of "hot money" flows, have fallen from their July peak. Given the challenges, bullion held up well. In our opinion, the removal of these more fickle funds paves the way for bullion's next leg higher.

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

MARKET PERFORMANCE

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

	31-OCT-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2242	-5.6%	-7.5%	-20.7%
CHF	1.0111	-1.8%	-2.0%	-0.1%
AUD	0.7609	-0.7%	+0.2%	+6.6%
JPY	104.82	-3.3%	-2.6.%	+15.1%
EUR	1.0981	-2.3%	-1.7%	-0.2%
BOND YIELDS (10 yr)				
UK	1.24	+0.50	+0.56	-0.68
US	1.83	+0.23	+0.37	-0.32
Germany	0.16	+0.28	+0.28	-0.36
Australia	2.35	+0.44	+0.47	-0.27
Japan	-0.05	+0.04	+0.14	-0.36
EQUITIES				
US. S&P 500 (USD)	2,126.15	-1.9%	-2.2%	+2.3%
UK. FTSE 100 (GBP)	6954.22	+0.8%	+3.4%	+9.3%
MSCI Europe ex UK (EUR)	1,144.56	+0.0%	+0.7%	-7.8%
Japan. Topix (JPY)	1,393.02	+5.3%	+5.3%	-10.6%
China. Shanghai Comp (RMB)	3,100.49	+3.2%	+4.1%	-8.3%
HK. Hang Seng (HKD)	22,934.54	-1.6%	+4.8%	+1.3%
Australia. All Ords (AUD)	5,402.44	-2.2%	-4.3%	+2.2%
MSCI Pacific ex Japan (USD)	1,188.35	-2.1%	-2.1%	+5.3%
MSCI World (USD)	1,690.92	-2.0%	-1.8%	-0.9%
MSCI World (GBP)	1,382.83	+3.9%	+6.2%	+25.2%
COMMODITIES				
Oil (WTI)	46.86	-4.0%	+6.9%	-10.2%
Gold	1,277.30	-2.9%	-5.5%	+11.8%

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