BENTLEY REID

INVESTMENT VIEWS

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EQUITIES	:	The Dow Jones hits 20,000 and Emerging Markets follow
BONDS	:	Treasuries pause whilst Bunds and Gilts slide
CURRENCIES	:	Profit taking in the US dollar as the Aussie surges
COMMODITIES	:	Gold recovers as industrial metals rally further

Just five days after the 20th January inauguration, the Dow Jones Industrial Average broke through 20,000 for the first time; it has now risen 10% since Trump's November election win. The new President was quick to take the credit, as the investment industry journal Barron's proclaimed "Next Stop, Dow 30,000". Despite this sense of heady euphoria, we have sympathy for a client who recently described markets as "high but hollow".

The stubborn deflation that has vexed Central Banks and dominated markets for most of the past decade is being challenged. The delayed impact of last year's huge Chinese credit splurge has reignited commodity inflation. In 2016, in a bid to head off a precipitous local slowdown, China funnelled credit equivalent to 25% of GDP into its economy. Even though most of this (some estimate 80%) was used to service or "ever green" existing debts, the net effect was a resuscitation of the "old" economy. By last autumn, Tier 1 annual property price inflation had touched 30%, whilst uncompetitive "zombie" factories restarted production; idle excess capacity was brought back to life.

We have rather jaded views about the sustainability and fragility of such debt fuelled growth. Regardless, the policy has underpinned a spike in raw material prices, thereby exporting input inflation to the rest of the world. G7 inflation ended 2016 at 1.6%, materially higher than the 0% 2015 low, with US and EU headline rates now at target. With most aspects of "Trumpenomics" forecast to amplify and broaden this inflationary pulse, bond yields and share prices have risen.

With oil prices and industrial metal prices 45% and 27% off their respective lows, the impact of such rises will all but ensure a further uptick in inflation numbers as we head towards spring. However, oil prices hit their nadir in late January last year, meaning that the inflation base effect will begin to wane unless we see further price rises. Furthermore, though Chinese credit continues to swell, there are clear signs that the Chinese authorities are trying to moderate loan growth. Whilst President Xi is keen to see stable employment in the run up to the autumn National Congress, he is aware of the threats posed to the system by evident asset bubbles and mounting bad debts. Absent a reacceleration of government support, Chinese credit (and a softer Renminbi?) will surely be less inflationary for the world as we move through this year.

Finally, with the US Federal Reserve projecting three base rate rises this year and openly discussing how and when to reduce its hoard of QE Treasuries, a firmer dollar and a rising cost of capital could also dampen American growth and inflation. Indeed, US housing activity is already slowing, as the average 30 year mortgage rate has risen from 3.3% to 4.1% over the last 4 months.

Of course, this is where the 45th President comes in. If he manages to convince both Republican Houses of Congress to agree his tax and regulatory reforms, particularly the proposed reduction in corporation tax rates, this could encourage a long delayed US corporate investment cycle; the average age of private fixed assets is the oldest since 1955. This could kick start aggregate demand and productivity, finally pushing US growth through its post crisis ceiling of 2% pa.

Will this come to pass? Will companies rediscover their “animal spirits” and use tax cuts to invest and lift real wages? Or will they continue, as they did during QE, to focus on returns to shareholders, favouring short term financial engineering (dividends, share buybacks) over productive investment? And what of the other Trump plans? An “adjustable border tax” (where tax deductions on imports are eliminated and exports revenues are tax exempt) seems confused. If you are a major exporter like Boeing, you obviously benefit. But what of the key importers like WalMart? Surely they will simply pass on the cost of higher import taxes, impoverishing the disgruntled voters who elected Trump? And lest we get US fixated, the impact of Chinese policy, as discussed above, will be of equal import, with the European political calendar waiting in the wings.

At this juncture, with Trump’s policy agenda still a work in progress, deciding if his approach will be inflationary or disinflationary is nigh on impossible. In this respect, the reaction of the dollar and the US 10 year Treasury to policy reality (not conjecture) bears watching. Measures of corporate investment will also carry weight.

Many investment doyens have come out in favour of higher inflation and resurgent growth. Indeed, they have been willing to pay up for it. With 2% revenue growth and flat earnings in 2016, the 10% rise in the US stock market last year was exclusively driven by multiple expansion. The US S&P500 now trades at 21 times its trailing earnings; the equivalent figure in 2008 was 17 times. Maybe we are unduly concerned and US profits do grow 12% this year, as currently forecast. If they do not, or the reflationary recovery narrative is in any way disrupted, the US market is chronically expensive on almost any measure.

Looking forward six months, if America is near full employment and Trump policies pack an inflationary bite, the post-election reflation trade could continue. Alternatively, we could see another disinflationary period if a firm dollar and the debt overhang crowds out the recovery. As such we continue to manage the balance between reflation and deflation assets, within a cautious headline risk allocation. Ultimately, we see inflation as the preferred option for addressing the world’s debts, but the path to this eventuality remains unclear.

IN OTHER NEWS…

Watching Teresa May holding hands with President Trump during her recent US trip, we are reminded that Valentine’s day is nearly upon us. Originally a Christian feast honouring early Saints named Valentinus, there are several related martyrdom stories. Saint Valentine of Rome, for example, was imprisoned by the Roman Empire for performing illegal weddings and ministering to Christians. He is thought to be the origin of the Valentine card; before he was led to his execution he penned a farewell note to the daughter of his jailer, signing it from "Your Valentine".

On a less romantic note, the day is also famous for the 1929 St Valentine's Day Massacre. Struggling to gain control of organised crime in Chicago, Al Capone arranged for 4 assassins to gun down 7 members of a rival gang, the North Side Irish. With two of them dressed as policemen and armed with pistols and 2 Thompson sub-machine guns (one of which had a 50 round drum), the shooters scythed down their unsuspecting targets. One of the victims lived long enough to answer police questions. Riddled with 14 bullet holes, when asked who shot him, Frank Gusenberg replied "No one shot me". He passed on shortly after.

EQUITIES

As we noted in the lead article, the post-election "Trump pump" briefly pushed the Dow Jones Industrial Average above 20,000. It finished the month up 0.5%, whilst the S&P 500 index gained 1.8%. Markets were led higher by technology and mining shares, although last year's winners in the energy sector lagged.

Federal Reserve Chair Janet Yellen indicated that interest rates would probably rise several times a year until they reach a sustainable rate of about 3% in 2019. US unemployment stands at 4.7% and the Fed's view is that the economy is nearing full employment. Since the election, business confidence has been rising strongly; the latest US manufacturing PMI reading of 56 reinforced this view (above 50 indicates expansion). This has yet to feed through to business investment; any sign of talk turning to action would provide grounds for optimism.

In the UK, the Supreme Court ruled that the government must give parliament a vote before it triggers Article 50 and EU secession. In a speech that heralded the start of negotiations, Prime Minister May outlined a hard Brexit, with the UK seeking a broad free trade agreement as a non-EU member, outside the customs union. Brexit secretary David Davis committed to publishing a white paper "as soon as is reasonably possible" as a concession to MPs. Mrs May is expected to serve formal notice at the meeting of EU leaders on March 9.

Theresa May scored a political triumph as the first foreign leader to visit the Trump White House. Although both sides were keen to discuss a possible trade deal, the visit was over-shadowed by Mr Trump's controversial executive order to ban travellers from seven predominantly Muslim countries - Iran, Iraq, Libya, Somalia, Sudan, Syria and Yemen. He said the order was about "terror and keeping our country safe". Acting US Attorney General Sally Yates refused to defend the order and was promptly dismissed for her "betrayal". Mrs May did her best to side-step the issue and instead extended an invitation for a full state visit. An online petition calling for this honour to be rescinded has raised 1.8m signatures and will now be formally debated in the House of Commons.

The FTSE 100 index fell by 0.6% as sterling rallied against the US dollar to $1.26. Over 70% of revenues for large UK companies are earned overseas, so the two tend to be negatively correlated. Currency was a major tailwind for earnings last year and could remain a prop at current depressed levels. Small cap UK stocks had another solid month, with the FTSE Small Cap index rising 1.2%; recent economic data points have allayed fears of a post-Brexit slump. UK GDP rose 0.6% in Q4, which defied moribund expectations of 0.1% growth.

The French election will take centre stage over the coming months. The first round is due to take place on 23rd April, with the second round on 7th May. Current polling for the first round puts National Front leader Marine Le Pen ahead of Republican candidate Francois Fillon (a self-confessed Thatcherite) and ex-Socialist Party member and creator of the 'En Marche' (onwards) movement Emmanuel Macron. None of the candidates have over 30% of the poll. The top two candidates from the first vote will battle it out in the second round. Francois Fillon's campaign has stumbled recently after a series of allegations in French magazine Le Canard. It is suggested that Mr Fillon's wife earned €830,000 over a period of 15 years, for little or no work, as a parliamentary assistant to her husband and his successor. The French police are now looking into the matter. That leaves Mr Macron as the front-runner with Marine Le Pen as 3/1 outsider. It would be foolish to discount her chances following electoral upsets elsewhere in 2016. Her growing chance of success was reflected in a widening spread between German and French government bonds. In the equity markets, the Eurostoxx 50 fell by 1.8% this month, whilst the Italian FTSE MIB index fell by 3.3%. The latter was dragged down by concerns over the viability of the Italian banking system. With the IMF once again (correctly) questioning Greek debt sustainability, some better individual company news is being drowned out by macro noise.

Emerging markets were aided by a softer US dollar and improved growth prospects. The MSCI EM index gained 3.9%. Having hit a post crisis low of 2.6% in 2016, the World Bank said global growth would accelerate to 2.7% this year. The main driver of the improvement is emerging markets where growth is forecast to expand to 4.2% from 3.4%. The Brazilian market fared particularly well, gaining 7.4%. The economy continues to recover from a deep slowdown, aided by a recovery in global commodity markets. Easing inflation is also enabling the Central Bank to reduce elevated real base rates; a major boon for local activity.

BONDS

Following the dramatic rise in yields after the US election, Treasuries paused for breath in January. The yield on a ten-year bond remained unchanged at 2.5%. US fourth-quarter GDP grew at 1.9% (annualised), below expectations of 2.2%; for the year as a whole the economy grew at 1.6%, well below its long term average rate. Inflation has been on a rising trend. The Core PCE rate that the Fed monitors stands at 1.7% today. Reflecting this inflation trend, US inflation linked bonds (TIPs) gained 0.8% this month. We still favour TIPs exposure over nominal Treasuries in the US.

In the UK, Government bond yields ticked higher. The FT All Stock Gilt index lost 1.7% as the yield on a ten year bond rose from 1.24% to 1.42%. UK CPI inflation rose to 1.6% in December from 1.2% in November. As we have touched on above, the base effect of commodity price rises will be a key driver of rising inflation. This month it showed up in air fares, food and fuel. UK index linked bonds gained 0.1% this month.

Despite rising inflation UK gilts continue to attract investors. A new 40-year UK bond drew the largest order book for a bond sold via syndication (i.e. placed through investment banks): £23bn of bids were made for a £4.3bn issue that matures in 2057. Pension funds, matching out long term liabilities, surely form the bulk of this price insensitive demand. With ten year yields trading at 1.4%, long dated gilts currently offer you a zero real return. We think sterling bonds remain vulnerable at these levels. Given the soft pound and elevated levels of political risk, cash is preferable.

European GDP growth remains subdued, but picked up to 0.5% in the final quarter, bringing the year on year figure to 1.8%. Coincidentally inflation also came in at 1.8%, surprising to the upside. The core inflation rate, which excludes the effect of energy prices, remained depressed at 0.9%. ECB president Mario Draghi suggested the energy effects will be transitory. Of particular importance was the pick-up in inflation in Germany where the CPI rose to 1.9% and core inflation picked up to 1.4%. With German elections later in the year, hawkish local politicians and the Bundesbank look set to pressure the ECB to moderate QE. This could support the Euro. Understandably, German bonds began to sell off. The yield on ten year paper rose from 0.2% to 0.43%.

CURRENCIES

The broad trade weighted dollar gave up much of its gain from the prior month. It fell 2.6% in January. Bullish sentiment began to wane after Mr Trump was quoted by the Wall Street Journal saying that the US dollar was already too strong, and it was making US companies uncompetitive against their Chinese counterparts. Mr Trump's top trade adviser Peter Navarro, the head of the new US National Trade Council, told the FT that the euro was grossly undervalued. The Euro appreciated by 2.7% against the US dollar this month. The Federal Reserve left rates unchanged at its meeting on 1st February, so the focus now moves to the next meeting in March. The market has priced in a roughly one-third chance of a rate rise at that meeting. With markets expecting inflation to rise to 2% in the medium term, a gradual pace of base rate normalisation seems likely.

Sterling gained 1.9% against the US dollar this month, appreciating to $1.26 from $1.23. UK Q4 economic growth of 1.6% was better than expected, bringing the full year rate to 2%. Strong levels of household spending helped to bolster the robust services sector. Bank of England governor Mark Carney did raise a note of caution about how sustainable this consumer-led activity might prove. Real wages are threatened by rising inflation.

The Australian dollar had a firm month, gaining more than 5% against the US dollar. Although the central bank rate remained unchanged at 1.5%, rising commodity prices and robust demand from China suggest the next rate move is up. Inflation rose to 1.5% in Q4, up from 1.3% in the prior quarter, whilst factory gate prices (which often lead future inflation) also ticked up by 0.7%. Other notably strong currencies included the Brazilian real, which rose 3.3% this month and is now up 25% versus this time last year. A recovery in the oversold currency was a key tenet behind our allocation to Latin American equities in early 2016. The Mexican Peso is now arguably at similarly cheap levels, given the negative impact of Trump's trade rhetoric.

GOLD/COMMODITIES

Oil prices slipped back 3% this month. US WTI crude finished the month trading at $52 a barrel, whilst European Brent prices fell to $55. Though still early days for the OPEC-led production cuts, early signs suggest a reasonable amount of compliance thus far. However, oil prices above $50 have encouraged a US shale oil renaissance. The Baker Hughes rig count (a measure of drilling activity) has risen from a low of 316 to 566, although it remains a long way from the high of 1,609 in October 2014 (when WTI crude demanded more than $80/barrel). US oil production has risen to 8.9m barrels per day. Hedge funds have lined up behind higher prices, with speculative interest in oil futures at record highs. Meanwhile, prospects for oil production in the North Sea look increasingly challenged. Royal Dutch Shell sold a raft of UK fields to Chrysaor, a small company backed by US private equity, for a price of $3.8bn.

Gold started the year in good form. It rose 5% to $1,210 on the back of a weaker US dollar and rising political uncertainty. Since the US election we have seen flows into the US stock market and US dollar, and out of safe haven assets such as gold. ETF holdings of gold declined a little to 56.8m troy ounces in January. We think the yellow metal offers a valuable hedge against further economic and political shocks.

Base metals also performed well this month as the Chinese manufacturing PMI remained in expansionary territory with a reading of 51.3. Zinc, aluminium and copper prices all rose this month. Copper gained 8% and is now just beneath $6,000/tonne. Prices were further supported by talk of a possible strike at the BHP Billiton Escondida mine in Chile. Workers voted against the latest wage offer from management. Although the metal is currently in a state of global surplus, any stoppage at the large mine would remove around 24,000 tons a week (source: Bloomberg) and potentially move the market into deficit.

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	OVERALL	EQUITIES	BONDS	ALTERNATIVES
+	ALTERNATIVES	Latin America	Inflation Linked	Uncorrelated Strategies, Gold
O		UK, Australian Asia, High Yield Technology Healthcare Resources	Australian	
–	EQUITIES BONDS	US, European Japanese	US, UK European Japanese Corporate High Yield	

MARKET PERFORMANCE

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

	31-JAN-17	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2579	+1.9%	+2.8%	-11.7%
CHF	1.0107	+3.0%	+0.0%	+3.4%
AUD	0.7585	+5.2%	-0.3%	+7.1%
JPY	112.80	+3.7%	-7.1%	+7.4%
EUR	1.0798	+2.7%	-1.7%	-0.3%
BOND YIELDS (10 yr)				
UK	1.42	+0.18	+0.17	-0.14
US	2.45	+0.01	+0.63	+0.53
Germany	0.43	+0.23	+0.27	+0.11
Australia	2.71	-0.05	+0.37	+0.08
Japan	0.08	+0.04	+0.13	-0.02
EQUITIES				
US. S&P 500 (USD)	2,278.87	+1.8%	+7.2%	+17.5%
UK. FTSE 100 (GBP)	7,099.15	-0.6%	+2.1%	+16.7%
MSCI Europe ex UK (EUR)	1,206.93	-0.3%	+5.4%	+5.9%
Japan. Topix (JPY)	1,521.67	+0.2%	+9.2%	+6.3%
China. Shanghai Comp (RMB)	3,159.17	+1.8%	+1.9%	+15.4%
HK. Hang Seng (HKD)	23,360.78	+6.2%	+1.9%	+18.7%
Australia. All Ords (AUD)	5,675.00	-0.8%	+5.0%	+12.2%
MSCI Pacific ex Japan (USD)	1,239.21	+5.7%	+4.3%	+20.0%
MSCI World (USD)	1,792.40	+2.4%	+6.0%	+14.7%
MSCI World (GBP)	1,425.94	+0.5%	+3.1%	+29.8%
COMMODITIES				
Oil (WTI)	52.81	-3.4%	+8.6%	+23.2%
Gold	1,210.65	+5.1%	-5.2%	+8.3%

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