BENTLEY REID

INVESTMENT VIEWS

MARCH 2017

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EQUITIES	:	Trump reflation euphoria pushes US indices to new highs
BONDS	:	Sovereign bonds recover despite rising inflation
CURRENCIES	:	Politics undermines sterling and the euro
COMMODITIES	:	Negative real yields help gold as oil drifts sideways

President Trump's speech to the Houses of Congress on the 28th February was notable for its more statesman like cadence. Bombastic rhetoric was replaced by a more conciliatory tone. That said, he gave little quarter on his legislative agenda, reaffirming his commitment to a Mexcian border wall, new immigration controls and a $1trn infrastructure investment. Detail on how he intends to reform the US tax code and finance his policies was notably absent.

This leaves the key inflation/deflation debate unresolved. Until his tax plans become clearer, it is difficult to assess how much of his policy program is realistically possible and over what time frame. As a result, as we noted last month, "At this juncture….deciding if his approach will be inflationary or disinflationary is nigh on impossible." This remains the case.

Indeed, the American economic picture remains mixed. Despite 4.8% unemployment, real wage growth remains depressed and inflation, though rising, shows little sign of a dramatic acceleration. Higher rates seem to be having an impact with pending home sales softening as rising mortgage rates bite. Asset markets have reflected this "hope versus reality" conundrum. During February, the bond market cooled on the reflation trade, with the 10 year Treasury yield falling from 2.6% to 2.4%. Conversely, equity investors continued to take Trump's promises of significant tax cuts and deregulation at face value. US stock indices hit new highs. Interestingly, business owners seem to be adopting a more cautious "wait & see" approach; corporate investment remains on hold whilst commercial and industrial bank lending has fallen back since the turn of the year. As a result, the Atlanta Federal Reserve cuts its first quarter real GDP growth estimate to 1.8% from 3.4% a month ago.

As we wait for some fiscal clarity from the Trump administration, the uncertainty of the European election calendar looms large. Our view that European populist parties will influence policy, but not triumph in forthcoming elections, remains broadly unchanged. The impressively coiffed Gert Wilders and his Eurosceptic PVV party will probably win the most seats at the March 15th Netherlands election. However, the PVV is predicted to achieve a minority share of the vote and, with all other major parties ruling out a PVV coalition, Mr Wilders is unlikely to grab the levers of power. In France

we feel a Front Nationale win remains unlikely. Though Marine Le Pen seems set to win the first round of voting on 23rd April, she is expected to lose by a wide margin when the vote narrows to 2 candidates in the second round. Both Mr Fillon and Mr Macron lead Le Pen by a double digit percentage margin in the second round polls.

The only real change has been in Germany where the appointment of Martin Schulz has revived the SPD. A former European Parliament President, "TheSchulz" (his twitter meme) is pro-Europe and more open to further member state integration than the current coalition. His left wing views echo the populist rhetoric of many protest parties without fundamentally challenging the status quo. His impact has been immediate and sizeable; if the September 24th election was held today, polls suggest he would become Chancellor. Merkel and the CDU are not the only losers; support for the far-right AfD has halved to about 8%.

With France, Italy and the Netherlands set to remain nominally pro-Europe, but critical of the EU to curtail local populism, a less fiscally austere Chancellor Schulz could be vital when dealing with the indebted southern states. In this regard, given the imperative to avoid a bail out during this nervous election year, Greek debt resolution will surely be postponed once more. Of more import is the parlous state of Italian finances.

With the 6th largest bond market in the world, the political and financial fragility of Italy matters. The European Central Bank (ECB) estimates that the top 14 Italian banks have €248bn of non performing exposures, equivalent to 10% of all Italian loans (*source: MacroStrategy, Reuters*). With productivity sliding, an ageing population and 40% youth unemployment, it is no surprise that the Italian structural deficit is set to rise to 2% of GDP in 2017 and 2.5% in 2018 (*source: European Commission*). This would push debt to GDP to 133%, a level widely accepted as unsustainable.

Capital flight is evident and accelerating. Eurozone Central Banks settle intra-member state payments via the ECB. In simplified terms, if investors sell an Italian Government bond and deposit the proceeds in Berlin, the capital flow creates an overdraft for the Bank of Italy and a credit for the Bundesbank; the accumulated values are called the target 2 balances. Unsurprisingly, the Bundesbank has a record target 2 credit balance of €754bn, a 50% increase on 2014. The Bank of Italy has a corresponding deficit of €365bn; another record. The Bundesbank has effectively provided over €350bn of funds to Italy via the ECB.

As Italy decides whether to call a summer election or delay until 2018, the countries "overt" and target 2 indebtedness continues to build. If, as seems distinctly possible, the elections lead to a Eurosceptic coalition, an Italian EU referendum will be discussed. Germany and other creditor nations are exposed. With only 42% of Italians feeling that the country is better off in the Eurozone (*source: Deutsche*), "Italexit" could steal the front pages from Trump as the summer months unfold.

IN OTHER NEWS…

From the Times newspaper - the death of Sir Ken Morrison, 85, robs the corporate world of a man unconstrained by the blandness that afflicts most top bosses. Shortly before he stepped down as WM Morrison chairman, he asked: "What's the difference between a supermarket trolley and a non-executive director?" His answer: "You can get more wine into a non-executive director."

He was clearly not a fan of non-execs, once declaring: "For the price of a non-executive I can get two checkout girls - and that's money well spent."

At the Morrisons AGM in 2014 he attacked the performance of Dalton Philips, the chief executive, by referring to his own new hobby of raising cattle: "I have something like 1,000 bullocks and having listened to your presentation, Dalton, you've got a lot more bullshit than me."

EQUITIES

With almost four months having passed since the US election the new administration continues to promise ill-defined pro-growth policies including tax reforms, financial sector deregulation and an infrastructure spending boom. To date, talk has trumped action. Whilst still early days, equity markets remain indulgent with valuations now pricing in a rapid improvement in corporate earnings; the MSCI World index gained almost 3% in dollar terms last month, led higher by US stocks. However, bond markets and gold bullion also rallied, suggesting some are more ambivalent.

US growth remains subdued with Q4 GDP coming in at just 1.9% annualised. The headline print was flattered by a surge in inventories as the post-election bounce in consumer and business confidence has encouraged firms to raise production. This re-stocking cycle is pre-empting an increase in demand that has yet to materialise; retail sales grew at just 0.4% m/m in January, whilst core capital goods orders fell, albeit after 3 consecutive months of gains. Regardless, the S&P 500 rallied by almost 4% in February.

In the UK, mid and small cap stocks have maintained their strong start to the year. The FTSE 250 added over 3% last month with the small-cap index gaining nearly 2%. The micro-cap AIM market has fared even better with an 8% gain this year. A number of its underlying constituents qualify for an inheritance tax break, which has prompted strong inflows into relatively illiquid stocks. We recently met with one of our specialist UK small-cap managers who conceded valuations in the asset class were looking stretched. He encouraged us to book some profits. We have since heeded his advice.

Further up the cap scale, the FTSE 100 was boosted by renewed sterling weakness; the pound fell almost 2% against the dollar as Brexit uncertainty weighed on the currency. Whilst the Article 50 bill was passed by MPs, the first vote in the House of Lords ended in defeat for the Prime Minister. The current sticking point revolves around the rights of EU citizens already living in the UK. Regardless, with the primacy of MPs unquestioned, it seems likely that the formal notification of the UK's withdrawal will be submitted to Brussels before the end of March deadline.

The FTSE 100 also benefited from Kraft-Heinz's unexpected U$143bn merger offer for Unilever, the UK listed consumer goods behemoth. The proposed deal was withdrawn after only 3 days when Unilever robustly rejected the offer as having "no merit, strategic or financial". Prime Minister May's prior criticism of Kraft's takeover of (UK based) Cadbury also suggested elevated political scrutiny.

Although such high profile mega-deals can often signal a market top, M&A activity is not yet at an extreme. Excluding the financial crisis, the number of transactions involving US firms in 2016 was the lowest since 2005. In value terms, deals totalled U$2trn, down from U$2.4trn in 2015. Like us, private equity firms appear concerned about high valuations.

European bourses kept pace with the global rally despite mounting political concerns. As noted above, the Dutch election takes place on 15th March with Geert Wilders' far-right Party for Freedom on course to win the most seats. His campaign has been dominated by an anti-EU, anti-Islam narrative. The looming French election has greater potential to upset markets, particularly with Marine Le Pen holding her ground in the polls. However, most European indices posted steady gains last month, buoyed by a weaker euro and sound economic data. News that Norway's U$900bn

sovereign wealth fund is being encouraged by the government to raise its target equity allocation from 60% to 70% also helped. According to the FT, the fund already owns an average 1.3% of every listed stock.

Turning east, Japan's Topix edged 1% higher in local currency terms, as the yen held against the dollar. Prime Minister Abe's seemingly successful US visit, which included a golfing weekend at the President's Mar-a-Lago Florida country club, eased concerns that Japan could become embroiled in a US led trade war. Trump declared he wants to bring the two countries "even closer".

At face value, US relations with China have also improved over the past few weeks with President Trump saying he would honour the "One China" policy that accepts Taiwan and mainland China as a single nation. This had been put in doubt when Trump had a phone conversation with his Taiwanese counterpart, shortly after his election; a political faux pas.

Chinese stocks rallied strongly last month. Despite a cooling east coast property market, the ongoing lending surge and rebounding "old economy" activity have driven financial stocks significantly higher this year. Domestic banks extended over CNY2trn of new credit in January, the second highest on record, with some of this liquidity funding stock purchases. Hong Kong 'H' shares have been amongst the main beneficiaries with the index spiking 5% last month, doubling its year-to-date return.

With cooling inflationary pressures, Brazil's Central Bank met expectations by cutting the Selic rate by 0.75% (to 12.25%) in February. This further boosted the equity market with the Bovespa rising by over 3%. Its 11% gain since the turn of the year leaves it as one of the best performing stock markets. The country's political situation remains distressed and President Temer's popularity has collapsed due to corruption allegations and his insistence on implementing unpopular economic reforms. With elevated real rates starting to fall, the economy has a decent structural tailwind.

It was though a gloomier month for Russian investors with the energy-heavy RTSI ($) index slumping by 6%. The oil and mining sectors both posted losses last month as growing commodity surpluses encouraged some profit taking. The Russian index trades on less than 10x trailing earnings; arguably cheap. However with the Trump/Putin "bromance" cooling, the political risk premium on Russian assets rose last month.

BONDS

Government bonds produced a strong recovery last month, unwinding some of the post US election reflation sell off. US Treasury prices firmed with the 10-year yield falling 0.1%, to 2.4%. We are a little perplexed by the recent demand for US debt. Inflation measures continue to tick higher, broadening out from healthcare and gasoline price pressures that have been prevalent for some time. Nominal 10 year yields are now in line with inflation.

Indeed, US core CPI rose to 2.3% y/y in January, the highest since last August. Because of this, and a seemingly tight labour market, the Fed is keen to raise rates several times in 2017. Chairwoman Yellen last month said "waiting too long to remove accommodation would be unwise". Futures markets are pricing in an 90% probability that the first rate hike will come at the March meeting.

Pre-election jitters are weighing on French sovereign debt prices. The yield difference between 10 year French and German Government bonds touched a multi-year high of 0.8%. The ECB's ultra-supportive liquidity stance has generally kept core European bond markets in check in recent years, but the prospect of a Front Nationale government is fraying investor nerves. Marine Le Pen looks set

to register a comfortable win in the first round of voting and, if the polls are to be believed, has a 40% chance of beating either Mr Fillon or Mr Macron in the second round run-off. Too close for comfort?

A rare batch of positive data pointing to a strengthening French economy added to the selling pressure on bonds. Q4 GDP growth accelerated to 0.4% q/q, with momentum carrying into 2017. The weak euro has driven the manufacturing PMI to a level not seen since 2011. Even though absolute levels of activity remain subdued this cyclical upturn is evident across the Eurozone.

Elsewhere, in Croatia, government action adumbrates how others might address excessive debt burdens. The Authorities have recently launched a "fresh start" scheme to wipe out the debts of the country's poorest citizens. To qualify debtors must owe less than 35,000 kuna (c.U$5,000) and earn less than 1,250 kuna each month. Private sector creditors are footing the bill. If deemed a success we may see other governments adopting a similar approach.

The UK gilt market was a lead performer last month with the 10-year yield falling 0.3% to 1.15%. This seems at odds with both the growth and inflation backdrops. Headline CPI reached 1.8% y/y in January, driven mainly by rising fuel costs. The monthly rate fell by 0.5% amidst discounting in clothing and household equipment. This may prove a temporary dip, as the impact of a weak sterling starts to appear; CPI is forecast to comfortably exceed the 2% target later this year. MPC member, Kristin Forbes, last month suggested rates may need to rise soon if growth and inflation remain solid. We expect the Bank of England to err on the side of caution and not raise rates; we retain our bearish outlook for gilts.

CURRENCIES

Sterling drifted almost 2% lower against the dollar last month. It now trades around U$1.24. Three consecutive months of falling retail sales volumes suggests the post-Brexit economic bounce may be running out of steam. A report in the Times newspaper, suggesting the government is preparing for a second Scottish independence Referendum, was another headwind. In spite of this, the demand for sterling assets remains robust; the Debt Management Office has just sold £2bn of a 2065 index-linked gilt at a record low real yield of -1.5%.

Political factors left the euro as the worst performing major currency in February. It fell over 2% to U$1.06. The latest ECB minutes suggest policymakers view the recent pickup in CPI to 1.8% as transitory; as such they remain wedded to their ultra-low monetary policy. Whilst the Dutch and French elections are dominating news headlines, the Greek debt crisis is flaring up again. The country needs conditional EU/IMF bailout funds to meet a €7bn loan repayment in July. The two main creditors remain at loggerheads, given the IMF's insistence on debt restructuring and implied write downs. The Fund believes that Greece will be unable to meet its liabilities, regardless of actions taken. The EU disagrees. The saga will drag on but signs of a compromise (fudge?) are already appearing.

The dollar sold-off against most emerging market currencies last month despite relatively hawkish Fed minutes. Two or three 2017 US rate hikes now seem priced in and a period of greenback consolidation is possible. Comments by the new Treasury Secretary, Steve Mnuchin, surrounding the potential issuance of 50 and 100-year Treasuries also weighed on the currency, as did various statements suggesting Trump favours a weaker dollar to boost export competitiveness.

GOLD/COMMODITIES

The gold price added 3% last month, continuing its run of good form. It is benefiting from a collapse in US real yields as the upturn in inflation has comfortably outpaced the gradual rise in nominal rates. This means inflation-adjusted yields are about to turn negative; a trend that typically supports bullion.

In energy markets, oil is holding steady despite rising supplies. Even though OPEC has achieved 90% compliance with its plan to cut daily production by 1.2 million barrels (compared to just 60% adherence when they last reduced quotas, in 2009) only 40% of non-OPEC nations are honouring the agreement. Furthermore, the US supply overhang is deepening. A rebound in shale production has driven US crude inventories to a record high and exports have spiked; the latter will offset some of the OPEC rationing. This coincides with record hedge fund speculative positions betting on further oil price gains. Given lacklustre real world demand growth, the oil market seems vulnerable.

Most industrial metals moved higher in February. Iron ore spiked by 11% on little obvious fundamental news. In fact, like oil, the market looks well supplied with stockpiles at Chinese ports also at an all-time high. We suspect the flood of credit being pumped into China's financial system is helping fuel speculative activity in commodity markets. The Chinese authorities are also suspicious; as the month drew to a close they announced an investigation into how hot money flows may be "distorting" commodity prices.

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	Asia Latin America	Inflation Linked	Uncorrelated Strategies, Gold
O		UK, Australian 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.

	28-FEB-17	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2380	-1.6%	-1.0%	-11.0%
CHF	0.9942	-1.6%	+1.1%	-0.7%
AUD	0.7657	+0.9%	+3.7%	+7.2%
JPY	112.77	+0.0%	+1.5%	-0.1%
EUR	1.0576	-2.1%	-0.1%	-2.7%
BOND YIELDS (10 yr)				
UK	1.15	-0.27	-0.27	-0.19
US	2.39	-0.06	+0.01	+0.66
Germany	0.21	-0.23	-0.07	+0.10
Australia	2.72	+0.01	+0.00	+0.32
Japan	0.05	-0.03	+0.03	+0.11
EQUITIES				
US. S&P 500 (USD)	2,363.64	+3.7%	+7.5%	+22.3%
UK. FTSE 100 (GBP)	7,263.44	+2.3%	+7.1%	+19.1%
MSCI Europe ex UK (EUR)	1,237.69	+2.5%	+8.3%	+12.1%
Japan. Topix (JPY)	1,535.32	+0.9%	+4.5%	+18.3%
China. Shanghai Comp (RMB)	3,241.73	+2.6%	-0.3%	+20.6%
HK. Hang Seng (HKD)	23,740.73	+1.6%	+4.2%	+24.2%
Australia. All Ords (AUD)	5,761.04	+1.5%	+4.7%	+16.4%
MSCI Pacific ex Japan (USD)	1,271.74	+2.6%	+7.7%	+24.1%
MSCI World (USD)	1,838.70	+2.6%	+7.4%	+18.8%
MSCI World (GBP)	1,480.79	+3.8%	+8.1%	+33.2%
COMMODITIES				
Oil (WTI)	54.01	+1.1%	+4.1%	+28.8%
Gold	1,248.33	+3.1%	+6.4%	+0.8%

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