INVESTMENT VIEWS

MAY 2017

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EQUITIES	:	Macron win aids European indices as UK election hits FTSE100
BONDS	:	Government yields little changed as "reflation" trade cools
CURRENCIES	:	The € and £ rise as the US and Aussie $ slide
COMMODITIES	:	Resurgent supply undermines industrial commodities

On April 18th, Teresa May unceremoniously dumped her polls promise, calling a General Election for June 8th. Under the fixed term parliament act, she inherited a mandate to 2020 but, with cross party support, the ballot was confirmed. The fixed term parliament act, introduced under David Cameron to prevent the incumbent tactically calling a General Election, failed. Its days are surely numbered.

The Prime Minister sold the election as an opportunity to reinforce her authority and to face down opposition to her approach to Brexit. In reality, though she talked of Labour and LibDem obstruction, with a slim majority of only 17 seats, the resistance lay within. May feels beholden to "hard" Brexit Tory factions who feel empowered to challenge her vision. Signs of economic deceleration and sluggish real wage growth also encouraged her change of heart.

If the polls are to be believed May looks set to win a landslide victory, including a majority in Wales (the first for over 100 years) and a dozen seats in Scotland. Though we expect her to be returned with an enhanced majority, we question the more gung-ho predictions. Equivocation over future tax rises and scrapping the Tory promise to protect pensions will temper core support. Furthermore, Labour supporters, dismayed by the woeful Corbyn, will surely prefer the LibDems as a refuge; they will join many Tory Remainers who see Tim Farron's party as the only credible opposition to untrammelled Tory Brexiteers. Farron will surely improve on Nick Clegg's 8 seats (from a possible 650) in 2015.

No matter. Markets see May using an emphatic win to corral the more precipitous, hard Brexit minority. Indeed, May seems to have accepted that Brexit will be a staged process, rather than a binary event (despite initial rhetoric). Even though the UK will probably relinquish its EU membership in March 2019, a multi-year transition period is expected to follow as exit details are agreed and implemented. A trade-weighted measure of Sterling has rallied 5% since the election statement.

For those who favour the Conservatives, this must all seem rather good news. A Prime Minister with a large majority; an implosion of the Labour party omnishambles and a spent UKIP consigned to

history. A firmer grip on the House would also enable the Tories to implement their long delayed change to constituency boundary lines. The alterations favour future Tory electoral prospects, verging on gerrymandering. Though the coming poll will surely expose a deficient opposition, we would temper Tory triumphalism. Whilst a strong British Prime Minister is desirable as the UK seeks an accord with its EU neighbours, the lack of a credible oppositions unsettles. Over-confident leaders tend to either abuse their power or over-reach. Thatcher fought the Unions, Blair battled Brown and Cameron wrestled a coalition; effective opposition is essential for considered democracy. Given the generational importance of her brief, one has to hope that May will be a careful steward of any landslide.

Across the channel, Emmanuel Macron, the French Presidential candidate, is expected to enjoy a similar margin of victory, though his prospects of unbridled power are less clear.

Having beaten Marine Le Pen of the "Front National" in the 1st round of the Presidential election, Macron and Le Pen now go head to head in the May 7th run-off. Current polls put him 20 points clear at 60% of the vote; it could be quite a bit closer. Le Pen is a shrewd politician who will have no difficulty painting her opponent, an ex-Rothschild banker and finance minister under Francois Hollande, as part of the ruling elite. Furthermore, turnout could be low as both candidates are unpalatable to many. This could favour Le Pen, given the committed nature of her core support. Even though we expect to see Macron succeed Hollande by a clear margin, whoever becomes the next President will likely struggle to implement their reforms.

The power to execute policy lies in the Presidents' relationship with the National Assembly (akin to Trump and the US Congress). Elections to the Assembly occur over two rounds between the 11th and 18th of June. Given the youth of Macron's "En Marche!" Party (it was only founded a year ago), the Assembly elections are expected to deliver a more fractured outcome; no one party is forecast to achieve a majority. If Macron has to rely on right wing Republican Party support (or other) to get things done, his reform aspirations will be tempered. This reality should also give comfort to those that fear a Le Pen victory; though 40% of the French voted for Eurosceptic parties in the 1st round, she would find her "Frexit" aspirations dashed on the rocks of a broadly Europhile Assembly.

The British Prime Minister is likely to enter the Brexit negotiations with a stronger domestic mandate. However, she will surely face a pro-EU cabal of senior European leaders given the French election result and the waning fortunes of the Eurosceptic parties in the Netherlands (the PVV) and Germany (the AfD). Though the UK election is important, unity across the other side of the Brussels table is of far greater significance as the real Brexit business gets under way.

IN OTHER NEWS…

A few more insights from our friend's annual list. Sticking with the political theme…

A developed country is not a place where poor people have cars. It's where the rich use public transportation – *Enrique Penalosa, Mayor of Bogota*

Always remember that the crowd that applauds your coronation is the same crowd that will applaud your beheading. People like a show – *Terry Pratchett*

And some light hearted ones to close...

The consolation is losing your libido. It's like being unchained from a lunatic – *George Melly on getting old*

I like to play chess with old men in the park, although it's hard to find thirty-two of them – *Emi Philips*

If you hadn't done all that running around playing football, do you think you would have been as thirsty? – *Caroline Aherne (as Mrs Merton) interviewing George Best*

EQUITIES

Calling a snap General Election failed to dent the performance of UK mid and small cap stocks which have staged an impressive rally since the Brexit vote. The FTSE 250 index added a further 3% last month with the small cap benchmark gaining 2%.

As outlined in the lead article, on June 8th the UK electorate will vote for a government for the second time in as many years as Prime Minister May seeks to capitalise on a 20-point poll lead over Labour. This prompted the pound to rally strongly last month, overshadowing a frosty first Downing Street meeting between the UK and EU negotiators. This undermined the multinational constituents of the FTSE 100 that benefit from a weak sterling; the mega-cap index fell 2%.

Politics also influenced European stocks in April with Emmanuel Macron's victory in the first round of the French Presidential election ensuring the final choice is between a centrist candidate and the Front National's Marine Le Pen. The final vote takes place on 7th May.

This sparked a sharp rally in European bank shares, particularly French names, as short-sellers were squeezed out of their negative bets. Investors had built large short positions in financial stocks ahead of the vote as traders sought protection against a potential head to head between two "Frexiteers"; bank shares would have tumbled if hard left candidate Jean-Luc Melenchon had finished in the top two alongside Le Pen. With the insurance strategies redundant, investors covered their bank shorts, driving prices sharply higher. This pushed the French CAC index 3% higher over the month with most European bourses posting a similar advance.

A positive start to the earnings season led to further gains in the US stock market; the S&P 500 added 1% in April. The end of the month marked President Trump's first 100 days in charge. Whilst he has signed a host of executive orders and sanctioned various military strikes in the Middle East, he is yet to deliver any meaningful domestic reforms.

The gap between Trump rhetoric and reality continues to widen. The administration unveiled what it calls "the biggest tax cuts in history," pledging to slash the corporate rate from 35% to 15%. It also proposed generous incentives for firms to repatriate overseas profits. However there was scant detail on timings and how the plan will be funded, leaving many investors (including ourselves) questioning the whereabouts of the Emperors clothes.

Otherwise news flow from corporate America has improved over the last few weeks. The first quarter earnings season is underway with the majority of firms beating forecasts. In aggregate, S&P 500 companies are growing earnings by over 12% year-on-year, led by the resource sectors. That said it is important to note that the Q1 2016 profit slump creates an easy base for annual comparisons; a clearer picture will emerge as summer unfolds.

Energy firms are back in the black with the mining and banking sectors also performing well. Conversely, consumer facing firms are struggling to grow profits amidst a marked slowdown in household spending and margin pressure born of input inflation. The accelerating shift from "bricks and mortar" retailing to online alternatives has been a key feature of the result so far; traditional retailers and related property plays are struggling.

The tech sector has been a lead performer with 16% profits growth, but much of the good news seems priced in given the stellar share price gains of recent months. Bloomberg reports that just 5 tech titans (Apple, Alphabet, Microsoft, Facebook and Amazon) account for a third of the S&P 500's 7% gain this year.

In Japan, the Topix recovered from mid-month weakness to end 1% higher (the same as the year to date return). It is one of the worst performing major markets of 2017. Partly payback after its surge in the second half of 2016, the Yen's surprising strength has also created a headwind for exporters. With firmer manufacturing data evident, any sign of Yen weakness would encourage us to reconsider our limited exposure to the country.

Elsewhere in Asia returns were subdued. The Kospi managed a 2% gain despite rising tensions between North Korea and the international community. Kim Jong-Un marked what would have been his grandfather's 105th birthday with a "cold war" parade of military might in Pyongyang. It followed February's test of a new intermediate-range ballistic missile, the Pukguksong-2. US and South Korean forces responded with large scale military exercises. The North Korean nuclear issue remains a clear risk given its ability to drag in all the major geopolitical players.

It was a tough month for Chinese stocks with the Shanghai Composite falling 2%. Weakness in commodity and financial names weighed on this "old economy" benchmark. Bank shares are struggling due to the government's clampdown on their more egregious lending practices and efforts to control run away property prices. Fears over rampant credit creation continued to mount; 7 trillion yuan of loans were created in the first quarter, equivalent to the size of Mexico's economy.

BONDS

The recovery in bond markets continued last month with sovereign and corporate prices moving higher. The US 10-year Treasury yield fell 0.04%, back below 2.3%, on signs of cooling economic activity and weaker inflation. The consumer price index (CPI) fell 0.3% during March, led by gasoline's 6% monthly fall. The "core" CPI (excluding food/energy) fell by 0.1%, suggesting that price moderation is not just commodity related. Auto prices fell for the third consecutive month as "big ticket" consumption continues to sag.

The year-to-date fall in US yields implies bond market doubts over further Fed rate rises in 2017. However there remain huge derivative bets on higher rates over the next few months. The net short position in 3 month Eurodollar futures (a bet on rising rates) has grown to over 3 million contracts; a record amount that, if unwound, would put downward pressure on US yields.

The UK Gilt market shrugged off the election news with prices little changed over the month, with 10 year yields ending at 1.1%. Although inflationary pressures are moderating in many economies they are more stubborn in the UK. The CPI rose by 0.4% m/m in March whilst Q1 GDP came in at 0.3% q/q, the weakest pace in a year. Cracks in the consumer sector are starting to show; retail sales contracted in the first quarter as inflation ate into households' purchasing power.

European bonds rallied last month as Macron's first-round success dealt a further blow to the region's populist movement. It comes just a month after Geert Wilders' poor showing in the Dutch election. With German Bund yields little changed and French OAT bonds rallying hard, the 10-year OAT/Bund spread fell back to just 0.5%. This gauge of risk appetite will deteriorate (ie. rise) if Le Pen prospects improve ahead of the 7th May vote.

CURRENCIES

The US dollar's consolidation continued in April with the trade-weighted DXY falling over 1%. Technical chart analysts note the index has now broken below the 100 support level, suggesting further downside is possible. Fundamental news flow adds weight to the argument. US economic data has disappointed of late with Q1 GDP expanding by just 0.7% annualised; less than half the prior quarter's rate of expansion.

After a brief rebound, US manufacturing activity is decelerating as companies bleed down excess inventories that accumulated over the past 12 months. The service sector also appears fragile with household spending under pressure amidst a slowing labour market. Non-farm payrolls grew by just 98,000 in March, having surpassed 200,000 in each of the prior two months. The decline has been attributed to an unseasonably warm start to the year which brought forward a lot of construction activity.

Much of the dollar's weakness came against the euro, which makes up 57% of the DXY basket. French political developments helped drive the single currency higher as did a raft of positive economic indicators. Eurozone Q1 purchasing manager indices evidenced strong momentum in both manufacturing and service sectors, led by the previous laggards, Italy and France.

It is too early to hail a European economic renaissance, particularly as the rebound has been driven by the weak euro; if current euro strength continues, it could choke off any recovery. However it does question the need for such ultra-easy monetary support. At last month's ECB press conference President Draghi acknowledged Europe's "cyclical upswing," sounding more hawkish than the committee's official, more dovish, statement.

The pound also rallied last month despite the soft Q1 GDP print. It had been struggling to break above U$1.25, but did so on the hope that an increased Tory majority could strengthen Prime Minister May's hand in the Brexit negotiations. Sterling's rally has been reinforced by investors covering extreme short positions. This could go a little further, but sterling's upside appears constrained by political uncertainty and a slowing domestic economy.

Finally, most emerging market currencies saw a bout of profit-taking last month after a period of outperformance. The Chinese yuan was flat as President Trump dropped his threat to label China a currency manipulator; Trump hopes his volte face will encourage President Xi to bring Kim Jong-Un to heal. In Australia, the dollar softened after a strong start to the year; broad based falls in commodity prices prompted a 2% fall against its US namesake.

GOLD/COMMODITIES

Resource markets came under pressure in April as the prior build up in inventories, particularly in oil and gasoline, weighed on prices. The CRB Raw Industrials index fell by 2% in dollar terms.

China's Q1 GDP came in at a better than expected 6.9% y/y, but activity remains reliant on government-backed construction and real estate investment. Capital Economics, a research firm,

notes that last year's pick up in Chinese demand for commodities was fuelled by optimism over future consumption of capital goods, rather than a surge in current activity. In fact, as is the case in the West, end demand remains subdued, which in turn has resulted in excess supplies for most base metals. China's National Statistics Bureau announced Q1 aluminium production was up 11% y/y, whilst crude steel output also surged. With demand growth lagging, prices are now falling back towards market clearing levels.

A similar dynamic is unfolding in the oil market with the "shale vs sheikhs" battle favouring the US producers; shale activity continues to rebound with US production back up to 9.3 million barrels per day (mbpd). This is dwarfed by OPEC's 32mbpd output, but the cartel's 2mbpd quota cuts are so far proving insufficient; the WTI oil price fell a further 3% last month, finishing at U$49/barrel. For OPEC, the problem is that many US producers are incentivised to ramp up production at this level (even if many remain unprofitable).

The gold price finished the month 1.5% higher at U$1,268/oz despite a late sell-off. It continues to benefit from a reappraisal of US monetary conditions. Earlier this year, the Fed seemed set on raising rates 3-4 times in 2017; this now seems unlikely. US macro conditions are deteriorating and bank lending has ground to a halt. If the Fed holds fire, low/negative real yields should keep bullion 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	OVERALL	EQUITIES	BONDS	ALTERNATIVES
+	ALTERNATIVES	Asia Latin America	Inflation Linked	Uncorrelated Strategies, Gold
O		UK, European Australian High Yield Technology Healthcare Resources	Australian	
–	EQUITIES BONDS	US, Japanese	US, UK European Japanese Corporate High Yield	

MARKET PERFORMANCE

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

	30-APR-17	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2951	+3.2%	+3.0%	-11.4%
CHF	1.0052	+0.8%	-0.5%	-3.6%
AUD	0.7488	-1.8%	-1.3%	-1.5%
JPY	111.49	-0.1%	+1.1%	-4.7%
EUR	1.0895	+2.3%	+0.9%	-4.9%
BOND YIELDS (10 yr)				
UK	1.08	-0.05	-0.33	-0.51
US	2.28	-0.11	-0.17	+0.45
Germany	0.32	-0.01	-0.12	+0.04
Australia	2.58	-0.13	-0.14	+0.06
Japan	0.01	-0.06	-0.07	+0.09
EQUITIES				
US. S&P 500 (USD)	2,384.20	+0.9%	+4.6%	+15.4%
UK. FTSE 100 (GBP)	7,203.94	-1.6%	+1.5%	+15.4%
MSCI Europe ex UK (EUR)	1,315.80	+2.2%	+9.0%	+16.1%
Japan. Topix (JPY)	1,531.80	+1.3%	+0.7%	+14.3%
China. Shanghai Comp (RMB)	3,154.66	-2.1%	-0.1%	+7.4%
HK. Hang Seng (HKD)	24,615.13	+2.1%	+5.4%	+16.8%
Australia. All Ords (AUD)	5,947.59	+0.7%	+4.8%	+11.9%
MSCI Pacific ex Japan (USD)	1,303.37	+0.4%	+5.2%	+12.1%
MSCI World (USD)	1,878.28	+1.3%	+4.8%	+12.4%
MSCI World (GBP)	1,450.41	-1.9%	+1.7%	+27.0%
COMMODITIES				
Oil (WTI)	49.33	-3.4%	-9.3%	+0.8%
Gold	1,268.29	+1.5%	+4.8%	-1.9%

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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
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