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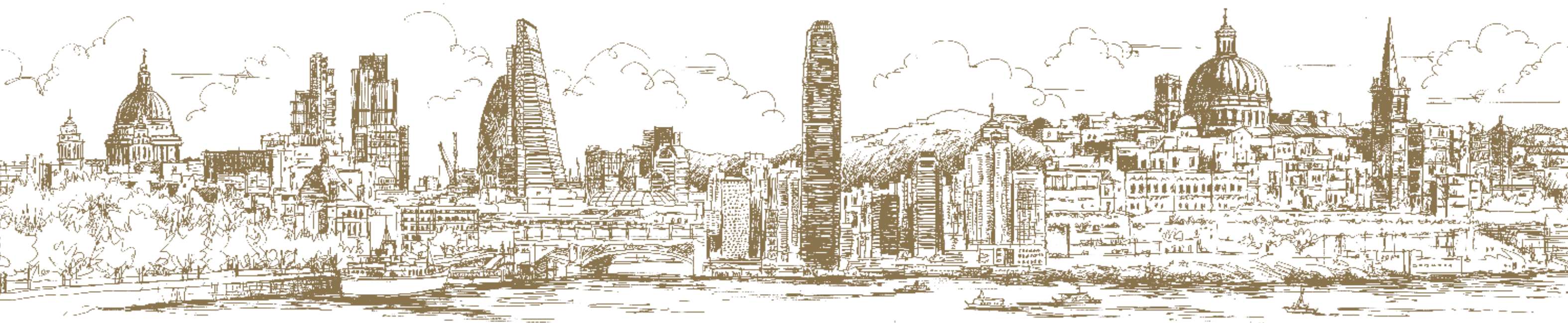

INVESTMENT VIEWS

SEPTEMBER 2017

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EQUITIES :	Tech and emerging markets lead despite North Korean worries
BONDS :	Global bond prices supported by less "hawkish" Central Banks
CURRENCIES :	The US dollar continues to slide as the euro & aussie rise
COMMODITIES :	Bullion is bid as on a soft US dollar and geopolitical tension

The Trump White House lurching from one crisis to another; a slump in popularity for the "EU reformer" Macron; Indian and Chinese border troops skirmishing and North Korea firing a missile over neighbouring Japan. So much for the summer lull.

Yet despite these geopolitical powder kegs, financial markets for the most part remain becalmed. The US S&P 500 and many other headline indices still trade around all-time highs, whilst the impressive recovery in emerging market assets continues. Beneath the calm exterior though some cracks in this 8 year bull market are beginning to show.

Regular readers will be well versed in our valuation concerns. In many regions, equity prices remain too high despite a solid earnings season that saw double-digit profits growth for the second consecutive quarter; the first such occurrence for 6 years in the US. However, overvaluation alone provides little guidance on when precisely a market will peak. Prices can remain detached from reality for an extended period and, as the adage goes, bull markets seldom die of old age.

So a catalyst is needed and the recent deterioration in numerous "internals" (technical indicators that help gauge the sustainability of a market move) provides food for thought. To start with, in many areas, asset price volatility has cratered. It's been almost 300 days since US stocks experienced a 5% fall; historically such a correction would tend to occur every 3-4 months. Concurrently, in July, the VIX "fear gauge" (an index that measures market expectations for US stock volatility) slumped to an all-time low. Like valuation, volatility is not necessarily an accurate tool for market timing, but at some stage this highly unusual period of market calm will end. We have sympathy for the belief that rivers of cheap QE cash have depressed volatility as investors borrowed to buy even the most modest market dip; that is worth remembering as chatter about less QE/quantitative tightening builds.

The response to what, at face value, were solid 2nd quarter earnings could provide a more time-sensitive insight. According to Factset, S&P 500 stocks that beat analyst forecasts witnessed a 0.3%

average decline from 2 days before the results. Typically, upside surprises are rewarded with an average 1.4% gain. These figures are one of many we monitor, but the negative reaction bears attention; the last time it happened was the 2nd quarter of 2011, just before the S&P 500 fell by 19% (peak-to-trough).

Moving on, it seems the bulls may be running out of steam with narrowing market breadth pointing to investor fatigue. When a broad cross-section of stocks are marching higher the chances of a major index setback are reduced; even if a few names fall by the wayside, plenty remain for the trend to endure. However, last month, the percentage of New York Stock Exchange shares trading above their 200-day moving average sank below 50%. Such a decline does not always herald a market-wide downturn, but a move below 60% has often proved a harbinger of more troubled times.

Major sector rotations are also developing with previous winners starting to flag. Every bull market has its clutch of flagship stocks with consumer staples and tech names dominating this time around. However, since early June, global staples stocks have underperformed despite a renewed fall in bond yields boosting the relative appeal of their attractive dividends. Are rich valuations finally proving an impediment or do investors see higher bond yields in the future?

Turning to the concentration of returns CLSA, a research and brokerage house, calculates that the largest 5 stocks in the S&P 500 (representing 13% of the index) have contributed a quarter of its year-to-date gain. All 5 are tech giants: Facebook, Apple, Microsoft, Amazon and Google. Whilst most of these market darlings retain decent price momentum, the room for disappointment is shrinking; it is a tight coterie of names driving the market higher.

Interestingly, despite the buzz around these tech oligopolies, investment flows are now retreating from the sector; liquidity support could be flagging. Data from Factset shows that over the past 3 months, consumer staples, tech and energy sector ETF's (tracker funds) saw the heaviest net redemptions. This comes despite news that retail investors are piling into equities; a classic late cycle sign. A recent AAII survey (American Association of Individual Investors) showed cash weightings in the average individual investor's portfolio at a 17 ½ year low, whilst Charles Schwab (a leading US stockbroker) saw the most retail account openings in the first half of the year since the hysteria of the 1990's dotcom bubble.

Bull markets tend to unfold in three distinct phases. Accumulation (when a brave minority of investors buy whilst prices and sentiment remain depressed), participation (when the majority return) and excess. Signs of retail investor capitulation suggest we have reached the final stage.

Finally, as the siren call of the FAANGs (Facebook, Amazon, Apple, Netflix, Google) lures retail investors into the broader equity market, the wild popularity of passive funds that simply track an asset market index, is a growing concern.

We have always advocated the selective use of passives, where active investment fails to beat the relevant index. However, the explosive growth of tracker funds means that massive investment flows over the last 7-8 years have been allocated to the largest stocks not (necessarily) the most fundamentally attractive. Valuation distortions are apparent. It will be interesting to see what happens if the markets ever reverse course. Furthermore, with the correlation between stocks and sectors tumbling, now seems a rational time to back active stock-pickers especially as active

managers can raise cash and underweight the expensive elements of a market; passive funds tend to underperform when markets fall.

Admittedly, most of the market internals highlighted above refer to US equities, but other areas are unlikely to decouple if the S&P500 struggles. With most European and emerging market equities boasting double-digit returns for the year, global markets look extended. As such we are increasingly comfortable with our elevated cash and gold bullion allocations, whilst remaining vigilant for opportunities to buy unloved, undervalued assets.

IN OTHER NEWS…

In 2017, the Edinburgh Festival Fringe turned 70. For 3 weeks in August, Edinburgh is swamped by visitors as one of the world's largest celebrations of arts and culture unfolds. Last year 50,266 performers staged 3,269 shows in 294 venues. We share a few groan inducing jokes that surfaced during this year's festivities.

"I'm not a fan of the new one pound coin, but then again, I don't like change" – *Ken Cheng*
"I have two boys, 5 and 6. We're no good at naming things in our house" – *Ed Byrne*
"Oregon leads America in both marital infidelity and clinical depression. What a sad state of affairs" – *Paul Savage*
"As a vegan, I think people who sell meat are disgusting; but apparently people who sell fruit and veg are grocer" – *Adele Cliff*

EQUITIES

Geopolitical risk is on the rise. North Korea's leader Kim Jong Un (or 'Kim Fatty the Third' as he is sometimes mocked by Chinese media) raised the stakes this month. North Korean state media reported that it had successfully tested a hydrogen bomb capable of being mounted on an intercontinental ballistic missile. The timing of the launch caused embarrassment for China, as it coincided with the opening of the BRICs (Brazil, Russia, India, China) summit in the Chinese city of Xiamen. China is North Korea's main trading partner and has taken some steps to punish the regime for its nuclear provocation. It has banned seafood imports in compliance with UN sanctions, and has agreed to stop importing coal and iron ore. However, China has so far stopped short of restricting oil and fuel exports to the country. US ambassador Nikki Haley failed in her request for stronger sanctions from the UN whilst warning that North Korea was "begging for war". For now, we do not expect Donald Trump's promise of "fire and fury" to come to pass but our sanguine view rests on our belief that China will control its errant neighbour.

The threat of nuclear Armageddon did little to disturb equity markets. Technology shares continued to lead the US market higher. Whilst the broad S&P 500 was up only 0.1% this month, the technology heavy Nasdaq index gained 1.3%. As Congress returns from its summer break, efforts will focus on potential tax reforms. However, progress will be closely linked to affordability and deficit levels. US debt ceiling negotiations loom large and the potential for a government shutdown in September, or a delayed one in December, should not be ignored. In the meantime President Trump has been distracted by the massive floods in Texas caused by Hurricane Harvey. He also found time to fire his chief strategist Steve Bannon; hopes for a less confrontational policy mix rise with his departure. Meanwhile business confidence measures remain near cyclical highs, as do equity valuations.

Brexit negotiations continue to cast a shadow over business activity in the UK. There has been little visible progress in negotiations to date. The UK parliament will soon vote on the Repeal Bill, which passes European law into British law. The Labour party has recently shifted its stance, opposing the Repeal Bill and calling for the UK to remain in the single market and customs union during any transition period. They are positioning themselves as the party of "soft Brexit". Shadow Brexit secretary Keir Starmer criticised the bill's failure to guarantee rights and protections for citizens. Despite Labour's protestations, the bill is likely to be passed by the Tory/DUP alliance.

Beyond politics, UK economic activity continues to soften. UK GDP growth for the second quarter was confirmed at just 0.3%. Leading indicators of economic activity suggest waning optimism in service and construction sectors, whilst manufacturing remains more robust partly as a function of a weak currency. The FTSE All Share rose 0.7% in August, whilst the mid cap FTSE 250 index gained 0.1%.

On the continent, Frau Merkel has been occupied with the September 24th German election. Polls suggest Merkel's CDU, along with its Bavarian CSU sister, will remain the largest party after the election but will fall short of an overall majority. This is not uncommon in Germany. Merkel would then, probably, pursue another 'Grand Coalition' with the SPD, which is led by Martin Schulz. Once the German election is out of the way, assuming she is returned as Chancellor, Merkel's efforts can return to Brexit and further European integration; it will be interesting to see how her policy imperatives evolve, given this would be her legacy defining, final term in office.

Over the border in France, Mr Macron is pressing ahead with his ambitious labour market reforms. Companies employing fewer than 50 workers – 95% of all French companies – will be able to negotiate employment terms directly with employees rather than via the unions. The reforms also include a cap on damages awarded by courts for unfair dismissal. The French Cabinet plans to approve the reform bill in the second half of the month, which could see it passed by parliament by the end of September. France's second largest union, the CGT, described the changes as a declaration of war, and has called for a day of strikes. However, the first and third largest unions have so far rejected calls for action. Mr Macron's tactics of divide and conquer may be working, even as his popularity slumps. Regardless, August saw Eurozone economic confidence rose to its highest level since July 2007 as the Euro Stoxx 50 index fell by -0.8%. Profit taking was evident as the strengthening euro cast a shadow over export earnings.

Emerging markets continued to be among the best performing markets globally as August saw the sixth straight month of US dollar weakness. The MSCI EM index gained 1.9%. Unsurprisingly the Korean market was amongst the weakest countries; the Kospi index fell by 1.6%. However, this was more than offset by gains elsewhere. In particular, Latin American markets fared well, with the MSCI Latin America index up by 4.3%. The Brazilian Bovespa market was especially strong, up 7.5%. Brazil finally emerged from its worst recession on record. Second quarter GDP grew 0.2%, the second consecutive quarter of growth after a 1% first quarter expansion. Consumer spending showed signs of stabilising as it increased 1.4%; it has contracted in the prior nine quarters. President Temer also announced a $14bn privatisation programme, which includes the sale of state run utility Electrobras. Our dedicated Asia and Latin America funds fared well and stand about 30% higher so far this year.

BONDS

The annual meeting of global central banks at Jackson Hole turned out to be somewhat of a damp squib. Neither Fed Chair Janet Yellen nor ECB President Mario Draghi offered any real comment of note, despite expectations that we might hear more about the future pace of monetary tightening. Instead Yellen opted to warn about the dangers of excessive bank de-regulation, distancing herself from the Trump agenda. Fixed Income markets took this as a relatively dovish sign, so bond prices rose and yields fell. The ten-year treasury yield closed 0.2% lower at 2.1%. The odds of a rate hike at the Fed's December meeting also shrank to 34%, down from over 60% during the summer. Bond markets are not signalling a sustainable take off in growth and inflation.

US unemployment ticked up to 4.4% this month, but remains low by historic standards. Real wage growth remains largely absent with US hourly earnings growth unchanged at 2.5%. The Fed will likely err on the side of accommodation until the debt ceiling debate has been resolved. Ratings agency S&P warned that a failure to raise the debt limit would trigger a government shut down and "would likely be more catastrophic to the economy than the 2008 failure of Lehman Brothers". A touch melodramatic, but you get the idea.

In the UK, the unemployment rate dropped to a 42-year low of 4.4%. However, real wage growth is still negative. Wage growth is running at just 2.1% whilst inflation stands at 2.6%. Political pressure to remove the public sector pay cap of 1% is building, with an announcement expected at the Conservative Party autumn conference. This could be the first of several fiscal boosts as politicians react to a financially pressured electorate; a key theme as we weigh up the unfolding inflation dynamic. Whilst domestic house-building activity remains strong, activity in the commercial sector fell to a 12-month low in August. Household consumption has also slowed. It grew by just 0.1% in the latest quarter as the weaker pound hit household budgets. Until the Brexit path becomes clearer, the risks to UK activity remain skewed to the downside. The ten year bond yield fell to 1.0% from 1.2%.

Eurozone economic indicators point to a slightly rosier picture. The leading PMI indicator (a measure of manufacturing activity) hit 57.4 in August, up from 56.6 in July. This is the highest level since 2011. Germany was especially strong touching 59.3. The Eurozone unemployment rate remains unchanged at 9.1%, as rising unemployment in Italy offset lower rates elsewhere. German CPI inflation rose by 1.8% in August, up from 1.5% in July. This was driven primarily by energy and food prices. Although some of the effect will be transitory in the face of a rising Euro, higher German inflation rates will inevitably pressure Mr Draghi to curb his ultra-loose monetary policy. Mindful of this, it was notable that he did not use Jackson Hole to try and talk down a resurgent Euro. As per the other major bond markets, German ten year bond yields fell over the month, edging 0.1% lower to 0.4%.

CURRENCIES

As mentioned above, the trade weighted US dollar declined in value for the sixth straight month; "its longest losing streak in 14 years" (source: the FT). The dollar is now 9% cheaper than at the start of the year. As we discussed last month, political deadlock in the US combined with better economic data in the Eurozone has seen assets flow from the US to other regions. Having recently broken out of a two and a half year trading range, the euro continued to appreciate against the greenback. The single currency finished the month at $1.19, having briefly broken through $1.20. The euro has gained 13% in value versus the

dollar in 2017. The Japanese yen was also notable for its strength, benefiting from its safe haven status. Our recent addition of Japanese equities on an unhedged basis should benefit from any further strength in the yen.

Sterling was the notable laggard this month. It fell by 2.2% against the US dollar and 2.7% against the euro. Now trading at $1.29 against the former, and €1.08 against the latter, it is starting to look cheap on a nominal and real effective exchange rate basis (i.e. taking into account inflation differentials). However, downside risks remain; most notably Brexit. The main sticking point in the negotiations looks to be the European commission's estimate of Britain's outstanding financial commitments (the 'divorce bill'). EU chief negotiator Michel Barnier has accused the UK of failing to recognise its obligations, whilst UK trade secretary Liam Fox accused Barnier of blackmail. Sterling will remain challenged if the rhetoric intensifies. We remain cautious on the pound at current levels.

The Chinese RMB was among the best performing major currencies this month. It gained 2% against the US dollar. It has appreciated by more than 5% this year and is now trading under RMB6.6 to the dollar. The Chinese economy is reported to have grown at a rate of 6.9% in both the first and second quarters this year, as direct and indirect Government policies continued to support domestic growth. Foreign trade was also a welcome boost to the manufacturing sector with first half year exports growing by 8.5%. A slightly stronger RMB offer stability as Chinese leaders prepare for the next party congress which opens in October. With President Xi set to consolidate his power base at the gathering, his subsequent use of a reinforced mandate will be key to many economic and political variables as we head towards Christmas and into 2018.

GOLD/COMMODITIES

North Korea's sabre rattling and a relatively dovish Fed helped gold to put on 4% this month. The price rose from $1,269 to $1,321 per troy ounce. Retail investors added 1.5 million troy ounces to gold ETFs and speculative long positions also increased. Bullion remains a core holding across portfolios, both as a geopolitical hedge and ongoing protection from incontinent monetary policy. That said another significant rally would probably lead us to bank some profits.

Base metals also fared well in August. The official Chinese PMI rebounded to 51.7 from 51.4 in July, whilst the unofficial Caixin PMI registered 51.6 (51.1 in July). Copper gained 7%, touching a 3 year high, and is now up 24% year to date. The move has been underpinned by a combination of robust Chinese demand for housing and new power grids; increased optimism about the take up of electric vehicles and some minor supply disruptions including shipping delays in Chile. Other base metals including aluminium, zinc and nickel followed coppers lead.

Hurricane Harvey and the subsequent flooding had a significant impact on the US oil market. Almost a week after the storm first hit land, almost a third of all US oil refineries were affected reducing demand for crude oil feedstock. Whilst the price of European Brent oil was unchanged during the month, US WTI oil fell by 6% to $47/barrel as inventories at Cushing, Oklahoma jumped by 1.4bn barrels. Conversely, gasoline prices spiked higher as fears about the refined products availability increased. The brief closure of the Colonial pipeline which carries fuel from the Gulf coast to the East coast reinforced the move. The average price of regular unleaded at the pump rose 15%, to $2.65 per gallon, over the month.

Agricultural commodities were marked down this month. Initially wheat, corn and soybean prices rose during the early summer as concerns over drought conditions took hold. However, most of this has now unwound. The US Department of Agriculture forecast that soybean and corn crop yields will be among the highest on record. Brazil, another key producer, has also recently delivered record harvests of both commodities. Wheat futures prices fell by 13% this month, corn by 7% and soybean by 6%.

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 Emerging Market	Uncorrelated Strategies, Gold
O		UK, European Japanese Australian High Yield Healthcare Resources	US, Australian	
–	EQUITIES BONDS	US, Technology	UK, European Japanese Corporate High Yield	

MARKET PERFORMANCE

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

	31-AUG-17	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2930	-2.2%	+0.3%	-1.6%
CHF	1.0430	+0.9%	+0.9%	+2.6%
AUD	0.7947	-0.7%	+7.0%	+5.7%
JPY	109.98	+0.3%	+0.7%	-6.0%
EUR	1.1910	+0.6%	+5.9%	+6.7%
BOND YIELDS (10 yr)				
UK	1.03	-0.20	-0.01	+0.39
US	2.12	-0.18	-0.09	+0.54
Germany	0.36	-0.18	+0.06	+0.43
Australia	2.71	+0.04	+0.33	+0.89
Japan	0.00	-0.07	-0.04	+0.08
EQUITIES				
US. S&P 500 (USD)	2,471.65	+0.1%	+2.5%	+13.9%
UK. FTSE 100 (GBP)	7,430.62	+0.8%	-1.2%	+9.6%
MSCI Europe ex UK (EUR)	1,296.52	-0.5%	-2.4%	+13.0%
Japan. Topix (JPY)	1,617.41	-0.1%	+3.1%	+21.7%
China. Shanghai Comp (RMB)	3,360.81	+2.7%	+7.8%	+8.9%
HK. Hang Seng (HKD)	27,970.30	+2.4%	+9.0%	+21.7%
Australia. All Ords (AUD)	5,776.25	+0.0%	+0.3%	+4.5%
MSCI Pacific ex Japan (USD)	1,354.31	-0.5%	+5.7%	+14.1%
MSCI World (USD)	1,959.74	-0.1%	+2.5%	+14.0%
MSCI World (GBP)	1,519.89	+2.2%	+2.5%	+16.2%
COMMODITIES				
Oil (WTI)	47.23	-6.0%	-3.4%	-4.3%
Gold	1,321.40	+4.1%	+4.1%	+0.9%

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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
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