BENTLEY REID

INVESTMENT VIEWS

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EQUITIES	:	A strong end to a record-breaking year
BONDS	:	ST rates bid higher as inflation fears mount
CURRENCIES	:	Sterling steady, but the dollar's slide resumes
COMMODITIES	:	Supply cuts underpin oil and metals

We view investment risk as the possibility or probability of permanent loss of capital; we are mindful that capital is hard to accumulate but easy to lose. In the investment world, volatility of returns is a much more widely favoured metric. To the technically minded, volatility is the dispersion or standard deviation of returns for a security. In layman's terms, it is how much an investment value rises and falls over time, the idea being that the more "bumpy" or volatile the return stream, the higher the risk.

Volatility has now sunk to generational lows across many global asset classes. In the US, during the 12 months after Trump's November 2016 election, the US stock market's average daily change was 0.31%; the lowest in over 50 years (*source: the FT*). Focusing in on equities (though the same applies to bonds), a decade of low interest rates has encouraged investors and companies to borrow to invest in stocks; in the latter case via vast share buyback programs that have reduced the S&P500 share count by about 3% p.a. (*source: S&P*).

This debt fuelled inflow has dampened the volatility of equity markets, reducing the depth and duration of market dips. As volatility fell, measures of market risk declined. This, in turn, encouraged rules-based, software driven investment strategies to unquestioningly take more risk, borrowing ever more money to bet on a continuation of the trend. A self-reinforcing cycle has developed, pushing asset markets ever higher, further away from underlying fundamentals.

This may seem a rather technical diatribe but so called "short volatility" strategies, that rest upon a continuation of uber-low volatility, now account for approximately U$2 trillion of investment assets (*source: Artemis Capital*). This represents a sizeable marginal investor that has a significant impact on the direction and volatility of markets.

Concurrently, as cheap money and low volatility has favoured momentum strategies over investment fundamentals, this has led to active managers under-performing passive tracker funds. Again, we have seen a self-reinforcing cycle as the market impact of passive fund inflows has further reduced the ability of active managers to outperform. As a result, investment into passive investment strategies (or tracker funds) has ballooned. Since 2007, passive equity funds have seen a cumulative inflow of U$2.4 trillion, almost exactly the same as the outflows from actively managed mutual funds (*source: BofAML*). Indeed, 37% of US domiciled investment funds are now passively managed, almost double that of 2009.

The bulk of tracker funds follow market cap weighted indices, where cash is invested in proportion to the constituent's value in a particular index. For example, every dollar that flows into an S&P500 equity index tracker will invest 3.6 cents or 3.6% into Apple, given the iPad makers value (U$870bn) versus the U$24 trillion capitalisation of the overall index.

This has amplified index concentration as the largest stocks are automatically "bid up" by the steady drum beat of tracker fund inflows. The top 5 US stocks by value are now all tech names; Apple, Alphabet (a.k.a. Google), Microsoft, Amazon and Facebook. They rose by over 45% (on average) in 2017 and account for 14% of the US equity index. They will thus receive 14% of every S&P500 tracker inflow, regardless of their prospects or valuation (NB. Amazon trades at 300 times its trailing earnings). Market concentration has increased. Indeed, at the time of writing, for the market value of Apple you could own all of Disney, Citigroup, Coca Cola, Nike, Goldman Sachs and Kraft Heinz.

Bringing these two key points together, why have we spent the Christmas break reading about and reviewing market volatility and the rise of passive investment?

As ever there are many things to consider as we deploy investment capital; this is normal and our list of economic, market and political salients has not changed with the advent of 2018. However, with many asset markets over-valued we are conscious that they could easily roil, if one of the "known unknowns" disturbs the current market calm and volatility surges. Interestingly, the cause of the disturbance is less important so long as it engenders rising market volatility. If this happens, the geared investment algorithms, that used low volatility as a pretext to buy, would rapidly become equally dispassionate and aggressive sellers. Similarly, as markets turned and redemptions arrived, tracker funds would unemotionally divest the entire market, not just the most expensive constituents. Correlations would be hard to predict, given the pervasive nature of geared investment flows, but these two key points could accelerate and amplify any market turn.

IN OTHER NEWS…

The growing frequency of Bitcoin enquiries seems to suggest that this hysteria may be peaking. Like many, we see value in the underlying (blockchain) technology, whilst condemning the digital currencies it supports as text book investment mania. Troy Asset Management summed it up nicely:

"The incremental buyer of bitcoin is less motivated to purchase because they are worried about fiat currency debasement, but because of a desperate fear of missing out…we share many of the monetary and financial concerns of the bitcoin pioneers, but put our faith in gold which has an illustrious history of preserving wealth and does not face the risk of being supplanted by a new digital rival. Gold is already a relic and should benefit as and when the fragile veneer of confidence enveloping bitcoin shatters." We also remain 'long' bullion…

On a different note, we enjoyed this passage, harvested from M&Gs Twitter feed:

At Columbia University the great linguist J. L. Austin once gave a lecture about language in which he explained how many languages employ the double negative to denote a positive – “he is not unlike his sister”, for example. “But there exists no language in which the equivalent is true,” said Austin. “There is no language that employs a double positive to make a negative.” At this point the philosopher Sidney Morgenbesser, sitting at the back of the lecture theatre, could be heard audibly scoffing, “yeah, yeah”.

EQUITIES

A rally in commodity prices gave fresh impetus to the “reflation trade” beneficiaries last month. Most regional stock indices finished the year strongly, led by the energy and mining names, whilst the Australian and Canadian dollars rebounded from recent falls. In contrast, short dated government bond markets remained under pressure with rising inflation rates causing yields to trend higher. Longer-dated issues remain largely immune with 10-year yields little changed last month; bond investors seemingly believe the inflationary pressures are unsustainable.

According to the International Monetary Fund (IMF) the global inflation rate accelerated to 3.8% y/y at the end of November, up from 3.2% at the start of the year (source: MacroStrategy). With the CRB Raw Industrials index (a benchmark for commodity prices) gaining a further 3% in December, an inflation narrative is likely to influence market moves in early 2018 too.

As noted in past editions, the commodity price gains can be mostly attributed to supply-side curtailments, but the demand outlook is also improving with a number of authorities finally introducing fiscal support measures; after months of hype surrounding tax cuts and higher government spending, political pledges are becoming a reality. President Trump’s “US Tax Cuts & Jobs Act” has garnered the most attention, but Japan and India have also unveiled significant tax cuts over the past month, whilst Saudi Arabia’s 2018 budget is the largest on record. Time will tell if this fiscal largesse will succeed where a decade of ultra-easy monetary policy has failed by engendering much higher rates of growth. Markets are ripe for disappointment if economies do not boom.

Much will depend on how China fares. As we suspected, a post-Congress slowdown in “old” economy indicators, including industrial production, freight rates and property construction is gaining traction as the authorities seek to temper the use of credit. The possibility of China becoming a less powerful source of global reflation has so far been discarded by risk assets; the Shanghai Composite index was little changed last month, but HK indices finished 2-3% higher.

The 1% gain in the S&P 500 meant it completed the calendar year without a single down month; an unprecedented feat. Its 6% fourth-quarter rally was fuelled by optimism the largest tax reforms since the Reagan-era will spark an economic renaissance. Small cap stocks have also benefited with the Russell 2000 index surging 13% from its August low despite last month’s 1% loss. US GDP growth has inched higher to 3%+ annualised, but it has been flattered by rising inventories rather than a robust acceleration in end demand. Without a meaningful boost from the tax cuts the economy remains vulnerable to a late-cycle slowdown meaning last year’s 10% profit growth for S&P 500 listings may be hard to repeat. We believe US equities remain priced for perfection, particularly with the relative valuation argument no longer favouring stocks; last month the 2-year US Treasury yield rose above the 1.8% S&P 500 dividend yield for the first time in 10 years.

After some last-minute to-and-fro between the Senate and House of Representatives, the tax bill was signed into law on 22nd December. The headline reforms are broadly as we outlined in last month's edition. There are individual tax breaks for all income levels until 2025, but most US households are unlikely to see the benefits until their 2018 tax returns are filed next year. With retail spending (excluding gasoline) struggling to gain traction, this may not be soon enough.

The permanent reduction in corporate tax from 35% to 21% could provide a more meaningful boost, but only if firms divert the savings into productivity-enhancing capital investments and/or wage hikes rather than simply buying back more of their own shares. The cut sparked a pop in the S&P 500's financial stocks, which at an average rate of 27.5%, were previously the index's highest tax payers. Conversely, the large-cap tech names were little changed last month, having already enjoyed an effective tax rate of just 19%.

Buoyed by his first major legislative win, President Trump took the opportunity to talk up a potential U$1trn infrastructure plan, but his efforts may be thwarted by Doug Jones' shock victory in last month's Alabama Senate race; he became the first Democratic Senator to win in the State for 25 years. It narrows the Republican's Senate majority to just 51-49, making it even tougher for the administration to pass further reforms ahead of November's mid-term elections.

Over in Japan, Prime Minister Abe enjoys a more supportive legislature. As the year drew to a close his Cabinet endorsed a record ¥97.5trn (U$860bn) budget for fiscal 2018. This should add momentum to a private sector that appears in rude health; the December manufacturing PMI rose to a 44-month high of 53.6 with a spike in new orders suggesting activity will remain solid in the first quarter. In response, the Topix index rallied by 1%, taking its quarterly gain to 9%. On a more sobering note, Macrostrategy states that roughly a quarter of the budget will be spent on servicing debts despite an average interest rate of just 1.1%. This begs the question of what happens if rates rise; a challenge many economies could encounter in 2018.

The European PMIs continue to boom, but the region's indices remain held back by the strong euro. In local currency terms, the MSCI Europe ex-UK index fell 0.6% last month. The political backdrop is another headwind with separatist parties winning 70 out of 135 seats in December's Catalonia elections. This deals a major blow to Prime Minister Rajoy who anticipated a straightforward victory, but he may up the ante by blocking the secessionists from forming a government. With the Italians announcing a general election on 4th March, politics looks set to remain a distraction to the Eurozone's cyclical recovery.

The bounce in resource stocks helped the FTSE 100 secure a 5% gain last month in what was an otherwise lacklustre year for the UK's principal index. In a reverse of the 2016 trend, sterling's relief rally has unwound much of the weak currency effect that boosted the mega-cap exporters after the Brexit vote. Mid and small cap stocks also made progress in December, but with Q3 GDP growth coming in at just 0.4% q/q, the economy appears increasingly fragile. We continue to book profits on more domestically focused names.

BONDS

Despite the weak growth environment, UK consumer and producer prices are accelerating. With CPI at 3.1% Governor Carney is obliged to write an open letter to Chancellor Hammond explaining why inflation is more than a percentage point away from the 2% target. He is likely to blame the weak pound, which has caused around two-thirds of the increase since Brexit. Unless the currency suffers renewed downside, this trend should ease over the coming months, but a 10-year gilt yield of 1.2% remains unappealing. Bond prices rose last month as the BoE signalled no more than 2 rate rises over the next 3 years, but if inflation remains elevated the market may take the decision out of their hands and demand higher yields.

The Federal Reserve raised rates by 0.25% as expected last month, taking the target range to 1.25-1.5%. In Yellen's last public outing as Fed Chair she relayed a relatively dovish outlook, signalling just 3 rates rises in 2018 and anticipating only a modest growth boost from the tax cuts. The unfunded nature of the reforms, which add up to $1.5trn to the US fiscal deficit, undermines the creditworthiness of the Treasury department and argues for a higher yield premium, but a 2-year yield of 1.9% is aligned with the Fed's estimate of only a handful more rate rises between now and the end of 2019. It has increased from 1.5% at the start of the fourth-quarter in response to higher inflation prints. US goods PPI rose to a 6-year high of 3.1% y/y in November, driven by a 16% annual gain in the price of gasoline. Excluding food, energy and trade, producer prices are rising at a less threatening 2.4% y/y, whilst core CPI is at a 3-year low of just 1.7%.

US services PPI suggests the consumer is struggling in the face of low real wage growth and higher input costs. One of the main contributors was a 3.1% y/y gain in the cost of servicing payday loans. With the household savings rate falling to a 10-year low of 2.9% it seems American consumers are borrowing more to finance day-to-day spending. It is worth noting a similar trend emerged ahead of the 2008/09 recession, which helps explain why the 10-year yield finished a choppy month at 2.4%, not far above the 2-year rate.

The Fed's rate rise triggered a raft of similar moves across the Middle East, where many currencies are pegged to the US dollar. In China, the PBoC increased its reverse repo rate by 0.05% to help support the yuan. A 2% rally in both the onshore and offshore Renminbi shows the policy worked, but the reluctance to raise rates by more suggests domestic liquidity conditions were already tightening; the authorities will not remove credit support too aggressively for fear of disrupting the economy. 3-month SHIBOR rose 1.5% over the year to 4.9%, whilst the bond curve remains inverted; at 3.9% the 3-year government bond yield is lower than its 3 month equivalent.

CURRENCIES

The pound has so far failed to break above its September U$1.36 high despite the eventful completion of Phase 1 Brexit talks. It was another testing episode for Prime Minister May who on 4th December arrived in Brussels expecting to announce a deal with her European counterparts. Her efforts were scuppered at the last minute when the Democratic Unionist Party (kingmakers for her fragile minority government) withdrew their support in protest at plans to keep Northern Ireland aligned with EU laws. Several days of frantic negotiations followed before a 7,200 word UK/EU joint agreement was finalised. It outlined what the UK owes the EU (up to £40bn), how the rights of UK/EU citizens living in each other's territories will be protected post-Brexit and a solution to the Northern Ireland issue.

A hard border with the Republic will be avoided by the mainland UK, in turn, accepting full regulatory alignment with Northern Ireland. Hard line Brexiteers argue this lays the foundation for quasi-single market membership; the prospect of a "soft" Brexit supported the pound last month, which finished unchanged at U$1.35. It was also aided by the government's humiliating loss in a House of Common's vote on the Brexit bill; eleven rebel Tory MPs backed an amendment that allows

Parliament a final say on exit terms. After a 10% annual gain, a lot of good Brexit news now seems priced into sterling, creating scope for renewed weakness should the trade talks stall over the coming months.

The dollar has received a raft of supportive news of late: US GDP growth of 3.3% annualised was the fastest in 3 years (albeit aided by inventory stockpiling), the Fed continues to hike short-term rates and President Trump finally delivered on his promise to cut taxes. Yet the response has been muted with the DXY trade-weighted basket off 1% last month; the bulk of the loss came against the euro. Fears over widening trade and fiscal deficits are likely weighing on the greenback; the budget shortfall amounts to 3.4% of GDP even before the U$1.5trn tax cut costs are taken into account.

Elsewhere, the South African Rand was last month's star performer with a 10% gain, spurred by Cyril Ramaphosa's election as Head of the ruling ANC party. He will succeed President Zuma when parliamentary elections take place in 2019, but there is talk that Zuma's departure could be expedited. The victor's anti-corruption manifesto was well received by financial markets, but with a number of Zuma loyalists retaining their positions implementing any reforms may prove challenging. The Indian political landscape is more supportive with Prime Minister Modi's BJP Party winning two regional elections last month, including his home state of Gujarat. The Indian Rupee continued its recovery with a 1% gain. Signs that the economy is back on track after last summer's implementation of a nationwide sales-tax also helped.

GOLD/COMMODITIES

Fledgling concerns about China's cooling property market prompted a correction in metals prices at the start of the month before an impressive V-shaped recovery took hold. Copper (7%) and aluminium (11%) posted solid gains as the authorities intensified their efforts to remove environmentally-unfriendly production. The anti-pollution shut downs are focused on Northern China, but have had mixed success. The PM2.5 fine particles indicator of air quality did not improve in 2017, raising suspicion that many plants are not complying with the output curbs. However, a ban on coal-fired heating has sparked an energy crisis in schools and residential areas, creating a surge in gas demand and a doubling of LNG prices over the final quarter.

Oil markets continue to tighten as a result of the various supply disruptions and a weather-related demand boost. Brent crude oil rallied 5% to U$67/barrel last month on the news a crack in the North Sea's Forties pipeline (which supplies 450,000 barrels per day) had forced it to close. Soon afterwards, Austria's main gas hub exploded; the Baumgarten plant acts as a conduit for around 10% of Europe's total gas demand.

Gold also finished the month strongly, gaining 2% to U$1,303/oz. The rise in short-term dollar rates has presented a headwind as has the general "risk on" sentiment pervading most asset classes. That said, we draw comfort from the fact bullion is making decent progress despite the challenging environment. It seems to be setting itself up for a sustainable spell above U$1,300/oz. A potential leg lower in the trade-weighted US dollar is one of several factors that could catalyse an extended rally in the price of bullion.

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
○		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-DEC-17	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.3513	-0.1%	+0.9%	+9.5%
CHF	1.0261	+0.9%	-0.6%	+4.5%
AUD	0.7809	+3.2%	-0.3%	+8.3%
JPY	112.69	-0.1%	-0.1%	+3.8%
EUR	1.2005	+0.8%	+1.6%	+14.1%
BOND YIELDS (10 yr)				
UK	1.19	-0.14	-0.17	-0.05
US	2.41	+0.00	+0.07	-0.04
Germany	0.42	+0.06	-0.04	+0.22
Australia	2.63	+0.13	-0.21	-0.14
Japan	0.04	+0.01	-0.02	+0.00
EQUITIES				
US. S&P 500 (USD)	2,673.61	+1.0%	+6.1%	+19.4%
UK. FTSE 100 (GBP)	7,687.77	+4.9%	+4.3%	+7.6%
MSCI Europe ex UK (EUR)	1,345.33	-0.6%	-0.2%	+11.1%
Japan. Topix (JPY)	1,817.56	+1.4%	+8.5%	+19.7%
China. Shanghai Comp (RMB)	3,307.17	-0.3%	-1.2%	+6.6%
HK. Hang Seng (HKD)	29,919.15	+2.5%	+8.6%	+36.0%
Australia. All Ords (AUD)	6,167.29	+1.8%	+7.4%	+7.8%
MSCI Pacific ex Japan (USD)	1,420.87	+3.6%	+6.3%	+21.2%
MSCI World (USD)	2,103.45	+1.3%	+5.1%	+20.1%
MSCI World (GBP)	1,555.35	+1.1%	+4.1%	+9.6%
COMMODITIES				
Oil (WTI)	60.42	+5.2%	+15.7%	+6.2%
Gold	1,303.05	+2.2%	+1.8%	+13.1%

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