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AUTUMN NOTE

Trump that!

7th November 2016

Analysts: Giles Rowe
Artur Baluszynski

There are few things sweeter to a long only investor than the smell of burning short sellers, and bears have had a tough time of it recently. The market's continued rise through the summer has confounded the pundits, with first China's and then Brexit Britain's collapses failing to materialise as forecast.

Sterling's plunge naturally compensated for the Referendum's outcome, greatly benefitting both UK exporters and our clients' portfolios given their weighting to overseas assets. Risks remain highly visible. A weak Sterling imports inflation, for a start. Theresa May's provocative 'Brexit means Brexit' speech gave EU hardliners an excuse to toughen their stance while the High Court's ruling on Article 50 throws the whole process into further chaos. China's debt mountain remains impressive, as does Europe's and indeed the UK's, so any sign of credit weakness or slower growth will put pressure on both bonds and equities. A Trump victory would raise more uncertainties. Will he trigger a reset, blaming the previous administration? So the Bull market should have plenty of worries to keep it in place. Danger comes when everybody thinks the sky is blue.

With negative and zero interest rates the new norm, higher valuations are justifiable arithmetically. Unless growth returns, we are now in a two-phase investment universe, one good, one bad. In the bad alternative, rates rise rapidly, and there are few places for investors to hide, even cash. In the benign one, currently prevailing interest rates remain low, and we have a new valuation baseline with higher PE ratios and lower yields. The long term chart suggests low interest rates are the result of powerful underlying forces that are hard to break. Would it even be possible to significantly raise interest rates right now? The benign phase could be here to stay for quite a while, despite events. We will know more come Tuesday night.

Yours Sincerely,

Giles Rowe

CEO&CIO

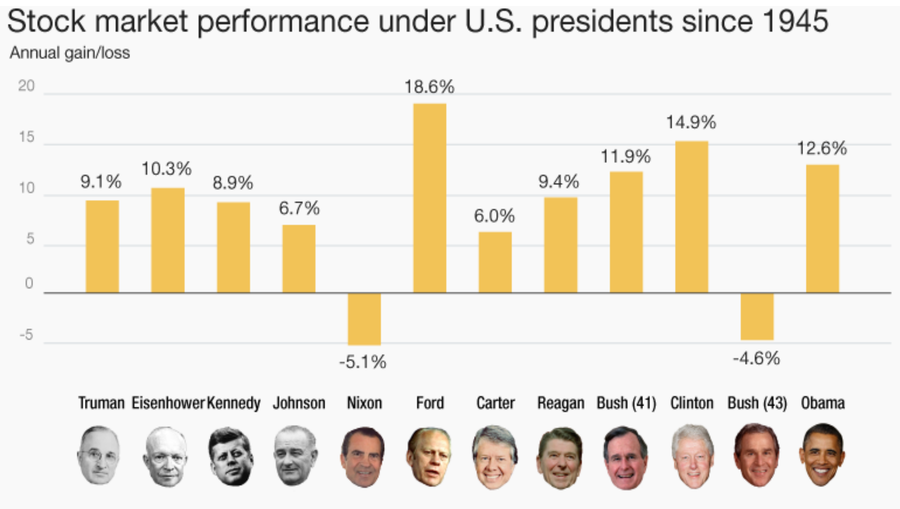

Chart Source: CNN Money

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EQUITIES

7th November 2016

Inflate that!

**Analysts: Giles Rowe
Artur Baluszynski**

Equity markets has been suffering from anxiety all year. In the most recent poll by the American Association of Individual Investors, a record percentage of market participants have a "neutral" outlook for stocks, reflecting high uncertainty. The year started with a strong sell-off, mid-way through we suffered Brexit and we will finish with a double whammy in the form of this week's elections and possibly a year-end US interest rate hike. Every time the market has wobbled it has quickly bounced back up again. Equity markets are still a strong proposition for global investors.

When the US presidential election is over, investors are likely to focus on the improved earnings outlook for energy and industrials, supportive financial conditions and pockets of attractive valuations for global equities. Inflation expectations are starting to move higher in the US, the UK, and Europe. Due to the recent commodity rally even the Chinese PPI has turned positive again, the first time since 2011.

Is inflation good or bad for equity markets? Historically markets have performed well with inflation below 4% as it benefits corporate pricing, while keeping central banks at bay. The US currently enjoys a continuing increase in average hourly earnings, which the Atlanta Federal Reserve Bank estimates at 3% next year. If Hillary Clinton wins, the Fed will have a green light to hike interest rates in December, a confirmation of a healthy US economy. If Trump wins, markets might be initially shaken by the increased uncertainty thanks to his maverick ideas on both domestic and foreign policy, but we would also expect a shift from monetary to fiscal policy. Trump's tax cuts and infrastructure spending might even boost domestic demand providing the medicine for growth. He may also create a much needed "pull" inflation due to wage growth and a looser regulatory environment. According to CNN Money, based on data since WWII, the US equity market performs best under a combination of a Republican president and a Republican congress.

We must not forget commodity price inflation, which should be a positive for many resource-exporting emerging markets. Despite so-called "rebalancing", energy and mining still play a major part in employment and wage inflation in most of Latin America and some Asian countries.

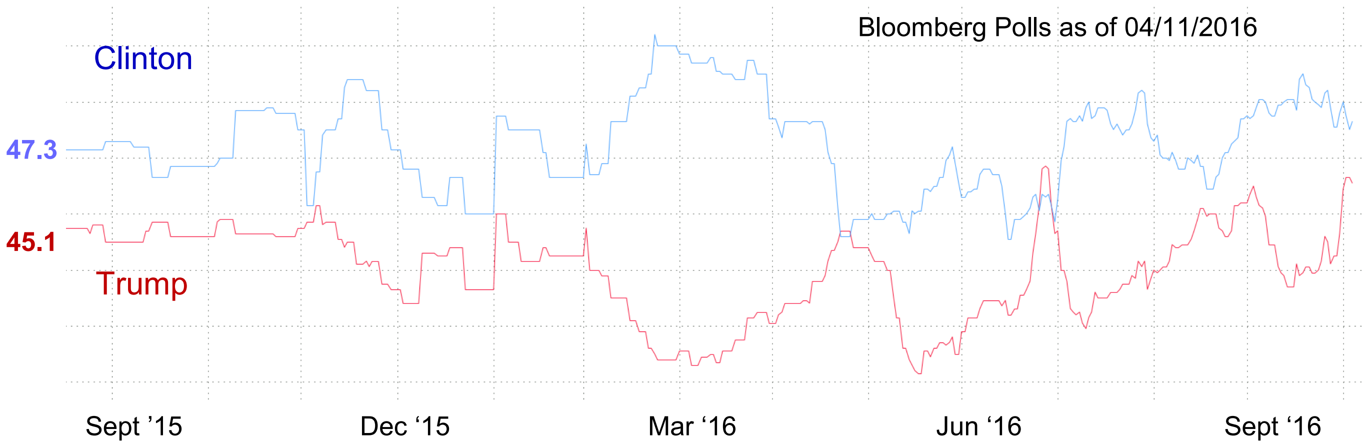

Chart: Bloomberg

Source: Bloomberg, CNN, AAII

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BONDS

7th November 2016

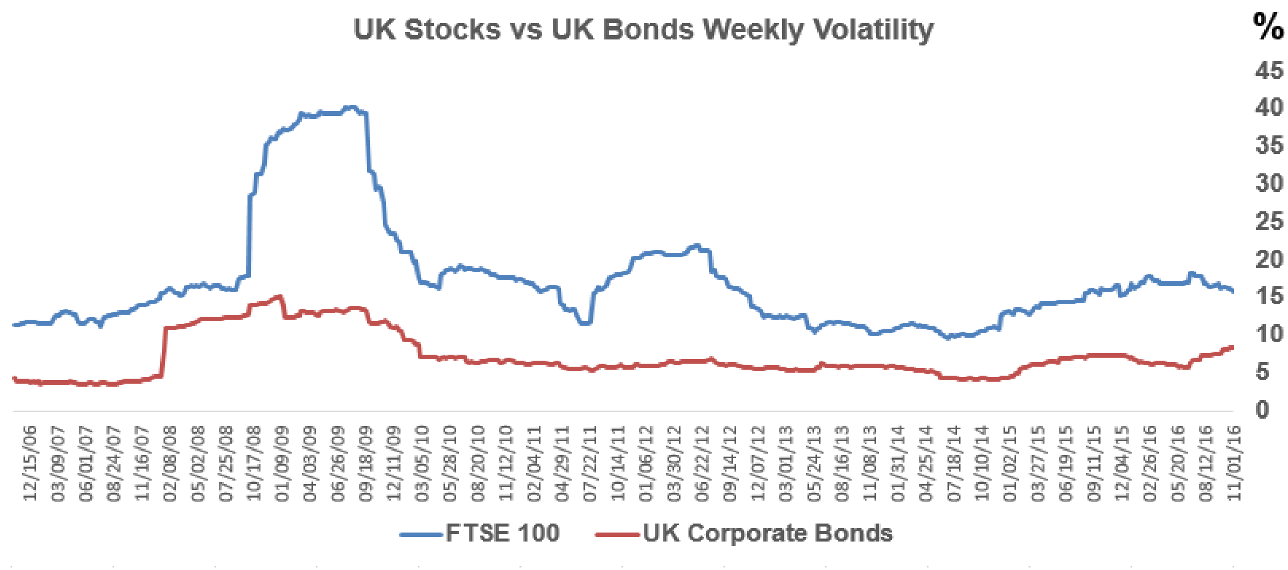
The Beginning of The End?

Analysts: Giles Rowe
Artur Baluszynski

According to Bloomberg, October 2016 has been the worst month for global bonds since 2010. Investors are concerned that central banks are preparing to gradually reduce the stimulus that has been driving bond and equity markets over the last nine years. As the US and UK economies start to perform, inflation fears are creeping into investors' minds and valuation models. Janet Yellen's remark in the last Fed meeting that the US is "running a high-pressure economy" has been seen as signalling the Fed's intention to run inflation above its target of 2%, bad news for long duration US government bonds. The big question is whether the QE driven bubble is being burst or whether the fixed income markets will continue their decades long rally. The recent rise in US and UK headline inflation is largely a product of recovery in energy, and commodity prices and some currency depreciation, not an increase in demand and wages. We have sold most of our UK nominal Gilt exposure since the Brexit vote but still have short duration corporate bonds and some inflation-linked bonds. There are major, long-term trends which could be a headwind to inflation in the developed world. These include offshoring, demographics and high levels of debt. Absent a currency crisis, elevated levels of inflation in the UK are very unlikely to last, especially if the property market weakens further.

There is no substitute for short duration US Treasuries as safe haven assets. So-called "bond proxies" might provide a higher income but will expose you to greater risk of loss. There are two points that investors need to consider before substituting stocks for bonds. First, stocks are historically about three times as volatile as bonds. Second, dividend payments to stockholders are not a contractual obligation. Dividend payments can be cut at the first hint of trouble. In fact, dividend cuts have been the first point of call for many energy and mining companies during the recent commodity price collapse.

While we have reduced our exposure to long duration US Treasuries and other "overvalued" corporate bonds, we see valuation issues in many high dividend stocks and high yield bonds too. If we want to boost our expected return, we will simply increase our allocation to stocks and not fool ourselves that we have found a new source of "safe" income.



Source: Bloomberg

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REAL ASSETS

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A Crane Too Far

Analysts: Giles Rowe
Artur Baluszynski

Property and Commodities are called 'Real' Assets because they are tangible, but just because you can touch them does not make valuing them any easier. The brutal collapse in oil prices from over $100 a barrel two years ago to a low of $30 as OPEC kept the tap running, has made the oil-and-gas industry a nasty place to be. But it is darkest before the dawn. GE's $32bn deal with Baker Hughes is a bet on the market recovering. GE is injecting its oil and gas business and $7.4bn in cash to create a new publicly listed company on the cheap. GE and peers see hope as the oil price rebounds to $50 and rig counts tick up. In metals too, there are signs that the six-year bear market may be bottoming, with the three month London Metals Exchange Copper contract hovering at $5,100, well above January's nightmare $4,300 low. In general, producers are no longer groaning under their massive debt mountains or talking of a commodity -driven financial crisis.

Property, on the other hand, has been enjoying an epic bull run that has littered the London landscape with cranes. The last Deloitte London Office crane survey back in March said 51 new schemes had started since the last survey, the most in their 20-year history. Total office construction had increased by 28% over the last six months to 14.2m sq. ft., the highest since Q1 2008. Since Brexit, London commercial property has sold off from the Summer's peaks while residential has faltered. Savills says prime residential was 8% below mid-2014 levels at the time of the vote. But weak Sterling has 'supported overseas demand' and a 0.25% rate cut has 'benefited domestic buyers'. Savills compares current conditions to the 2002 to 2004 period when debt costs remained stable and property prices fell only 10% after a bull run. The market will likely wait and see while Brexit negotiations unfold, with London's position as a financial centre critical.

Property feels late cycle and commodities ready for renewal, but turning points are hard to gauge precisely and we are generally looking for exit points in the former and bargains in the latter.

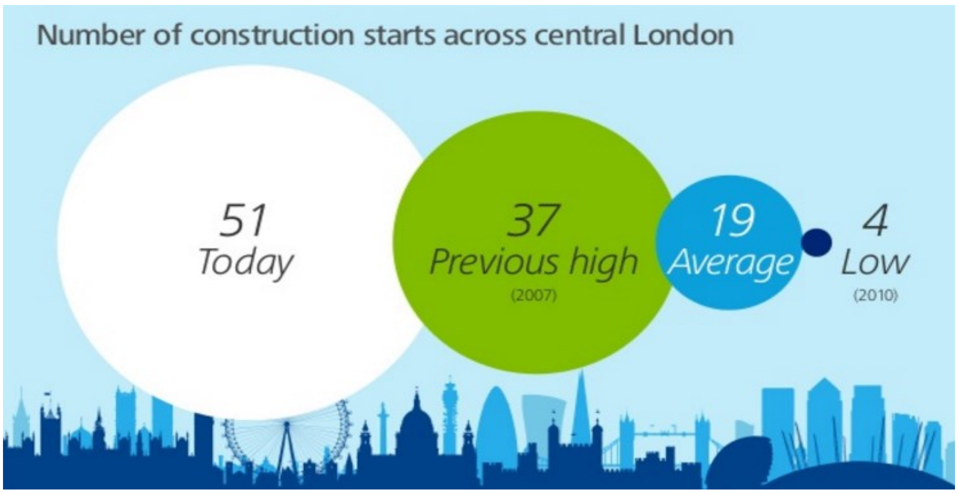

Chart: Deloitte London Office crane survey

Source: Bloomberg, Deloitte, Savills

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