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SUMMER NOTE

NO PAIN, NO GAIN

14th July 2015

Analysts: Giles Rowe
Artur Baluszynski

Former Greek finance minister Yanis Varoufakis says Germany's hardball tactics are meant to show France what the end of the road looks like. Let's hope the lesson has been absorbed.

China has had a painful education too. Hundreds of thousands of retail speculators have ridden the Chinese market up 100% since November, then rode it down again. At one point from peak to trough the drop on the Shanghai Composite was around US$2.3 trillion, giving back most of the US$3.5 trillion gains on the way up. China is bouncing now as regulators pull all the levers, including arresting sellers. Here is the key: Chinese, European, Japanese and other authorities continue to pump in stimulus to counter the pain of each crisis. In Europe Wolfgang Schäuble ensured the lesson hurt as much as possible. 'No pain, no gain'. The exit from multi-year bond and debt bubbles and the restoration of growth has yet to be managed.

It is easy to obsess with the wrong side of the balance sheet. Both equity and debt are forms of liability, and investors also need to look through to the assets earning the returns. Here we see exciting things, a historic phase shift in technologies revolutionising productivity, an Eastward move in economic participation, and a third shift maybe just around the corner in energy. All three will greatly enhance wealth creation but are disruptive. The shocks we have seen to World equity markets in the last two decades are similar to the turbulence in US markets at the dawn of the last century. Huge economic forces are ripping through fragile financial structures but creating a world with unprecedented levels of wealth and participation. On the near view, we are seeing good growth in the global economy despite Greece and China.

Volatility creates opportunities and we are ready to take advantage of any that present over the Summer.

Giles Rowe

CEO / CIO

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Shanghai Composite Index
July 2012 to July 2015

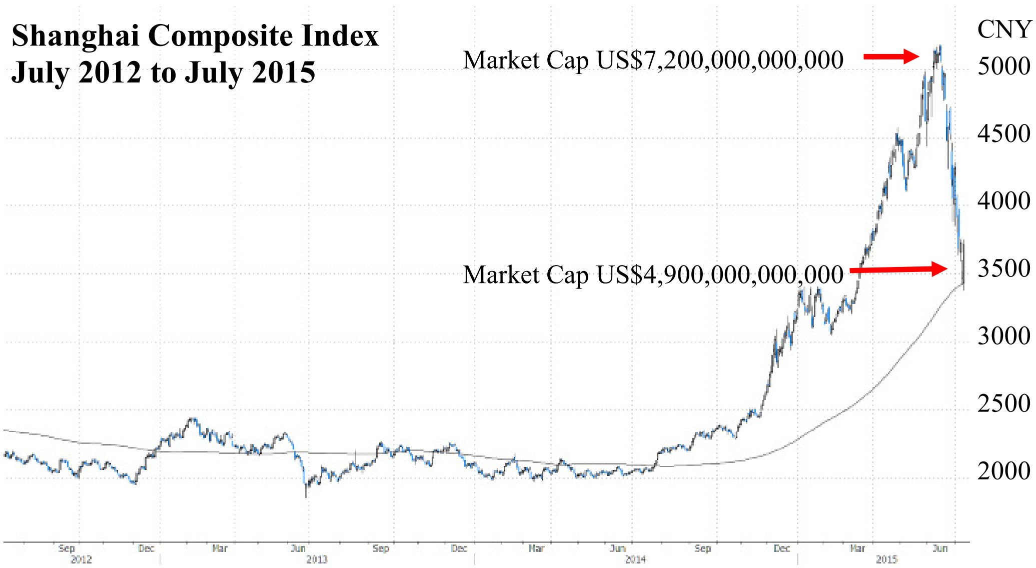

Chart source: Bloomberg

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EQUITIES

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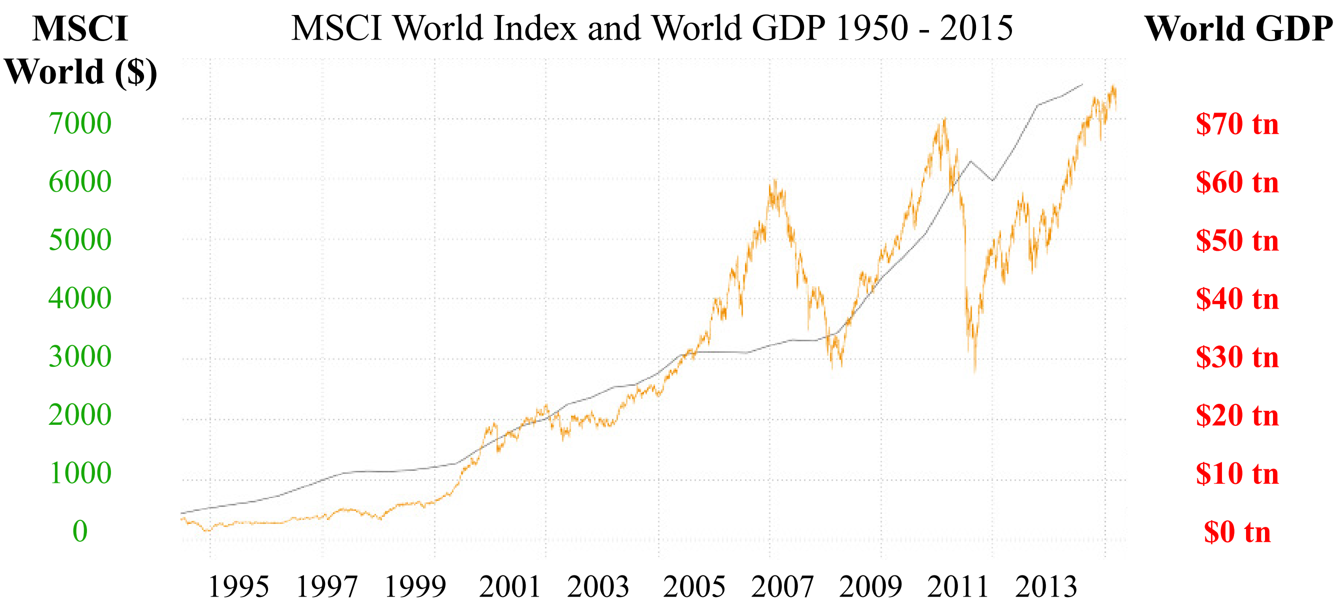
KEEPING PACE

Equity markets look vertiginous, a massive peak soaring higher than the last two in 2000 and 2007. Investors can be forgiven for worrying about this but do not need to do so unduly.

A frequently used gauge of value is the ‘Warren Buffet Indicator’, the Wilshire 5000 Index against US GDP. At present, this indicates US stocks are overvalued. But in April, Buffet said markets were ‘not too frothy’. We agree. The chart at the bottom compares the MSCI World Index of equity stocks against the World Bank’s record of the World’s GDP, both in US $’s. They are shown coming from the same base in 1970 and climbing. The GDP path is relatively smooth while the World Index has the volatility typical of equity markets. Equities are on a par with GDP.

As the table shows, the MSCI World and other major markets are not cheap but are still offering decent earnings and even dividend yields compared to bonds. These look sustainable. Morgan Stanley expects developed market demand to lead growth with a 4% increase in the second half of 2015 and points out that monetary stimulus is being expanded by 18 central banks. Credit Suisse sees growth in the US and Japan. The IMF thinks the world economy will grow 3.3% in 2015, slightly down on previous forecast but still healthy. We have taken a few positions off the table and have our eyes on their replacements, briefly reducing our equity weightings.

	MSCI WORLD	S&P 500 INDEX	FTSE ALL-SHARE INDEX	BLOOMBERG EUROPEAN 500	SHANGHAI SE COMPOSITE	NIKKEI 225
PE Ratio	18.0 x	18.4 x	21.4 x	22.3 x	18.9 x	22.5 x
Earnings Yield	5.6 %	5.4 %	4.7 %	4.5 %	5.3 %	4.4 %
Dividend Yield	2.5 %	2.1 %	3.7 %	3.5 %	1.9 %	1.6 %
Price/NBV	2.2 x	2.8 x	1.9 x	1.9 x	2.2 x	1.8 x



Data sources: Bloomberg , Chart source: Bloomberg

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BONDS

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READY, STEADY, AIM...AIM...AIM!

Analysts: Giles Rowe
Artur Baluszynski

In April, volatility made its way back into bond markets. Ten year German Bunds dropped almost 8% in a month while the ten year US Treasuries recorded a 5% correction. This was driven by the strength of US and Euro data and a favourable election result in the UK.

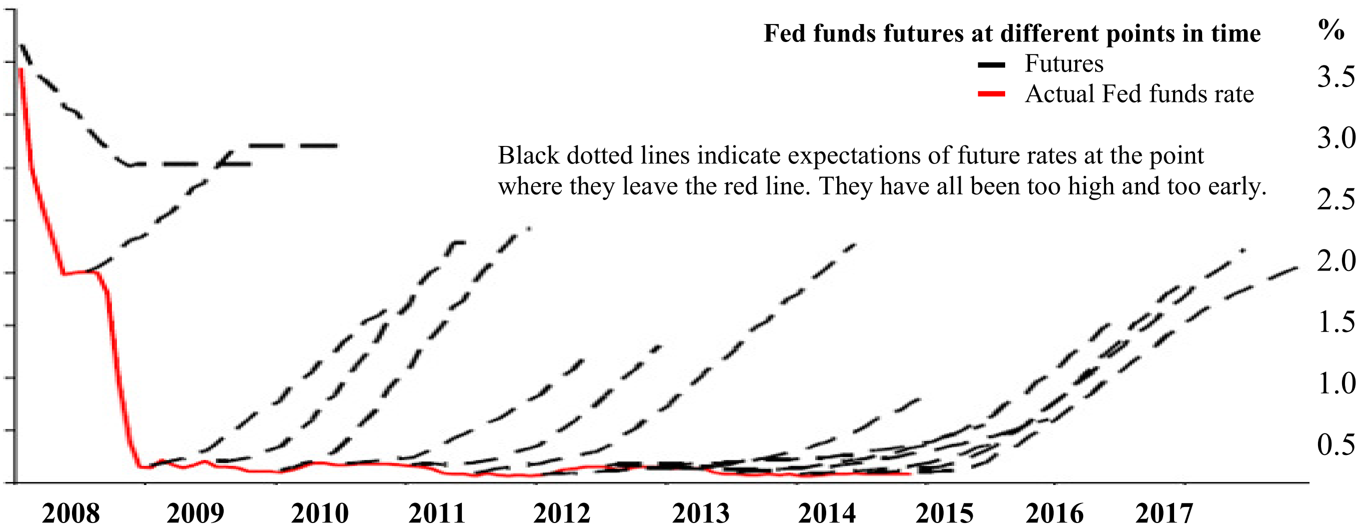
Then came June. The Greek drama entered yet another chapter and the Chinese stock market bubble started deflating. Global investors seeking safety pushed UK, US and core Euro bonds to trade higher by early July.

Bond markets have been as exciting as equity ones for the last two years. Financial news channels see more economists, academics and market forecasters than ever before. Everyone is trying to guess the date of the first interest rate hike in the US and next quarter's inflation level. But making a "quick buck" out of bond markets is extremely difficult. Even the likes of Bill Gross get their thesis right but are awfully wrong on timing.

Cash provides a negative return after inflation and developed world bonds will most likely return low single digits over the medium term. But we still see a role for selective bond investing in some of our conservative, balanced and growth portfolios. The recent possibility of "haircuts" to depositors in Greek banks has shown that cash in a savings account is not cash! Saver's deposits have a long history of being raided by governments either through financial repression or haircuts. Decent quality bonds are unlikely to be subject to government raids.

In July, we made some small changes by selling specific names that were overvalued or where the risk/return scenario wasn't in our favour. For many clients we still hold bonds backed by a good asset base with a yield to maturity equal to or higher than the bond's duration.

If the Fed decides to raise rates this year, no market will be safe from short term volatility. We expect the hike cycle to be gradual due to lingering global disinflation. We are not making a one way bet solely on an inflation or deflation scenario but plan for both. Economic forecasters still see September as the month for an interest rate hike in the US but as shown on the chart below their forecasting skills are as good as guessing.



Data sources: Bloomberg, Chart source: Deutsche Bank 2015

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COMMODITIES

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Artur Baluszynski

SANITY FREE

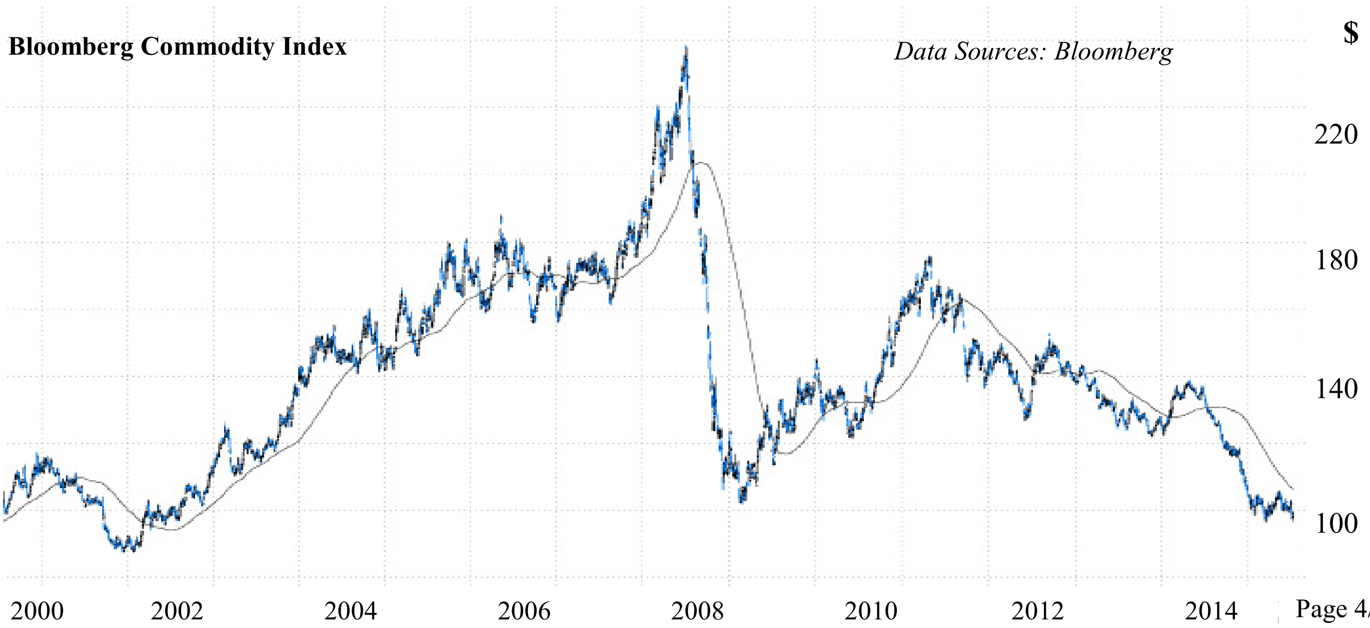
Oil dropped seven percentage points on 6th July as Greek headlines reached a particularly hysterical pitch. Equally large oil price rises earlier in the year met less fanfare.

We are very wary of picking bottoms but can not help beginning to be quite excited by the outrageous negativity in the fossil fuel sector. Everywhere we look, committees of the great and the good are disinvesting, mainly from coal and tar sands but also more widely on social responsibility and environmental grounds. Syracuse, Glasgow, Oxford, Bedford, SOAS and many other Universities, the Lutheran World Federation, Church of England and World Council of Churches have joined the Wellcome Trust, Bill & Melinda Gates Foundations and Guardian Media Group in ditching fossil fuels, complying with various 'Fossil Free' campaigns. A 2013 report by Sir Nick Stern claimed fossil fuel reserves are overvalued and could be creating an investment bubble. That is one risk not to worry about any more! If the 2006 Stern report into the Economics of Climate Change had been fully implemented, the world economy would have ground to a halt and global warming delayed by a couple of years. At an annual cost of 4% of GDP, net benefits would not be positive till 2120.

Other forces are at play, including lower demand, which has pummelled coal, copper and iron ore prices. The coal sector in particular is being punished, sector stock prices down as much as 99% from 2011 peaks and bonds trading at distress levels. 'Fossil Free' is not disinvesting at a high.

How much lower can commodity prices go? The Bloomberg Commodity Index has dropped a massive 45% since 2011's peak and 60% since 2008. Price movements at market lows are often extreme, hence the 7% intraday oil move this month. The chart below shows the entire asset class below 2009 levels, near 2001 lows which are now the next support. Corn and Wheat have recently sported nice rallies but are still in primary downtrends.

Some oil companies do have the flexibility to ride the storm, cutting capex and costs and are beginning to look attractively valued. We still hold Randgold Resources and a Premier Oil bond.



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