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SUMMER NOTE

Crisis, what Crisis?

19th July 2016

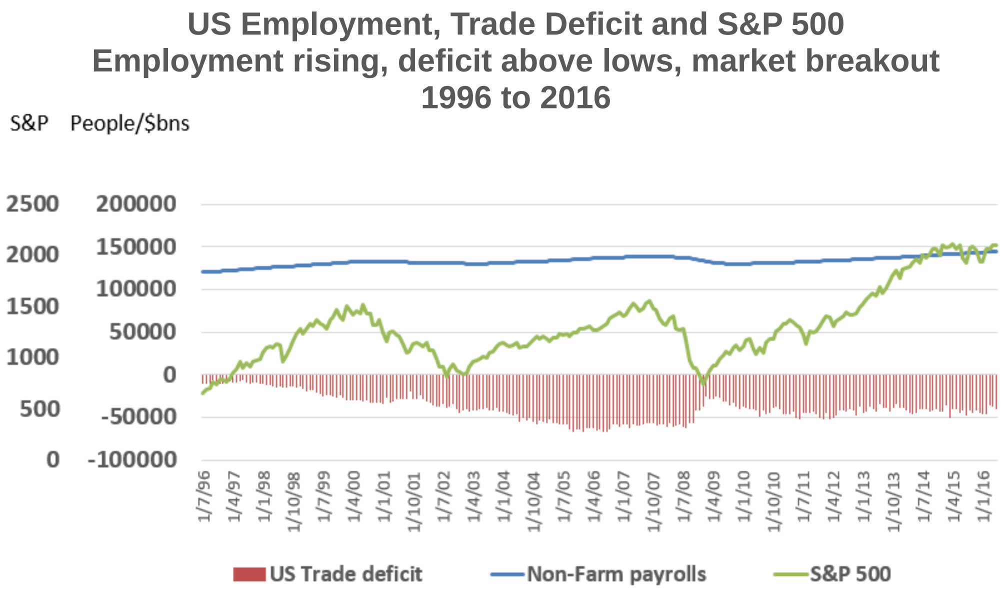
**Analysts: Giles Rowe
Artur Baluszynski**

The main lesson of recent events is that referenda are incredibly bad ways of solving issues on which there are deep divisions. On the bright side, our portfolios have weathered the Brexit storm quite well given that we expected a Remain vote. We had modelled the likely impact of a 'Leave' outcome using a steep Sterling and Equity market fall, which showed that our international positioning was defensive. In the event, Sterling fell more than equity markets and we experienced significant gains. If we had Remained, we think there would have been a relief rally in global equities and possibly in Sterling but to a smaller degree. Sterling is picking up now despite continuing challenges. Whether the UK enjoys headwinds or tailwinds remains to be seen. Late cycle property is the most vulnerable sector.

Brexit stressed markets for a few days and they have already moved on, while China managed to sneak in a further Yuan devaluation during the turmoil without triggering a panic.

It is European markets that are now most in the frame, as they stomach the British public's impromptu lesson in democracy. Politics and immigration aside, the banking system is the main issue again. Italy's growth has stopped since joining the Euro and its government debt to GDP is above 140%. Italy's banking system is burdened with around €400bn of non-performing loans. A large capital injection is needed urgently, despite EU state-aid rules and Mrs Merkel. Obdurate for now, Mrs Merkel may prove less of an obstacle when it comes to bailing out basket case Deutsche Bank to avoid a German banking crisis.

The US is a glass half full in the run up to the presidential election. Like Brexit, Le Pen and ISIS, Trump is a lightning rod for deep cycle dissatisfactions and the big question is whether the current world order is under threat. A more mundane question is whether the US consumer (c. 70% of GDP) will be able to drive growth in the teeth of weakening capital investment and exports. June's 252,000 job growth was much higher than May's 72,000 and the market is ecstatic. The chart below shows a strong US employment trend, stable trade deficit and a market heading into new high ground.



Source:Bloomberg

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EQUITIES

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Flying High

Analysts: Giles Rowe
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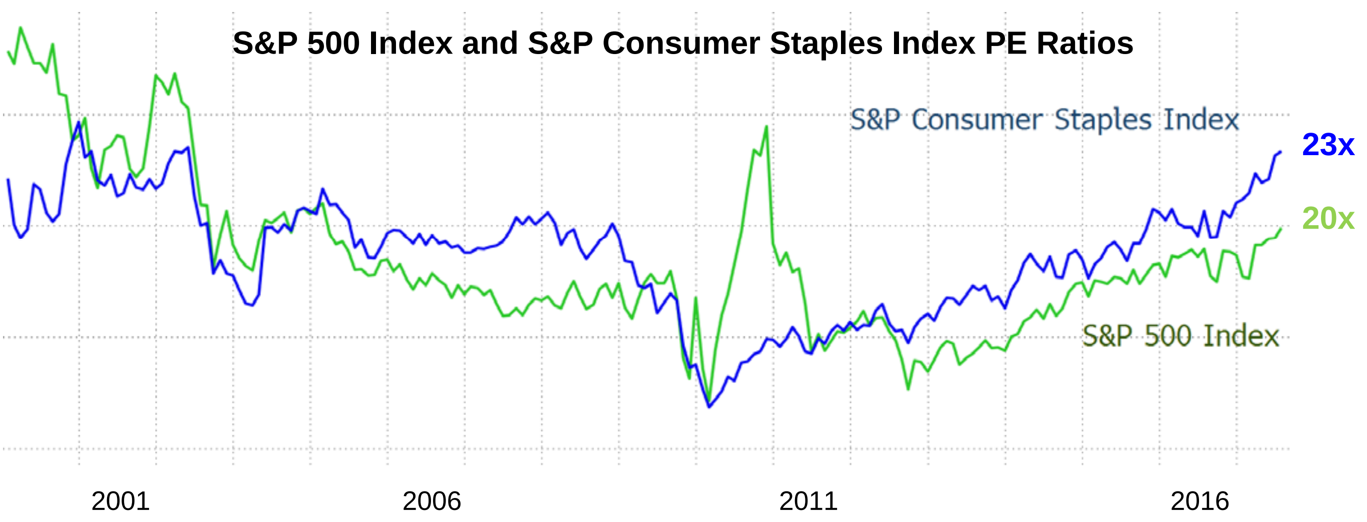
Most equity indices have recovered since the referendum vote with the FTSE 100 recording a stunning 7% rally and emerging markets up 6%. In large part, they are riding the expectation of further "easing" from central banks. The FTSE 100 is fairly "defensive" with more than 60% of its revenue coming from outside the UK, making it a beneficiary of Sterling's fall.

Domestic and cyclical sectors, UK Property and banks are most at risk, but some of that has already been reflected by the market with the likes of banks and housebuilders seeing substantial downgrades. Healthcare and consumer staples, including tobacco have been top performing sectors for many years now and despite hefty valuations, continue to attract more capital looking for safety under the "quality" umbrella.

Quality stocks, or stocks where the underlying business is believed to have a so called "moat" have been in high demand since the financial crisis. However, some of these sectors are now trading at demanding valuations as pessimistic investors looking for safety are ready to buy good balance sheets at any cost. The S&P 500 Consumer Staples sector Index is trading at a Price to Earnings ratio of 23x, the highest in more than a decade. With most investment grade bonds yielding close to zero, investors are forced to focus on relative rather than absolute valuations. Simply put, some shares are perceived to trade at expensive levels because bonds are expensive. Big institutions have already jumped in on this bandwagon and created numerous passive products tracking this sector.

Most of our clients know we are big fans of "quality" stocks, ones with sustainable high returns on capital, but not at any price. In a slow growth environment some "moats" may be challenged. Less efficient competitors are kept alive by low interest rates and new competitors can take advantage of low cost of capital and cheap technology, so we mix our high quality stocks with opportunistic buying of undervalued securities. Some temporarily depressed cyclical sectors like industrials look attractive and we continue to invest in a few specialised companies in the UK and Europe, whose business models are likely to weather difficult economic and political environments.



Source: Bloomberg

Prices can go down as well as up. Past performance is not a guide to the future and estimates are subject to uncertainty. Please see the important notice at the end of this document.

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BONDS

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Into the basement

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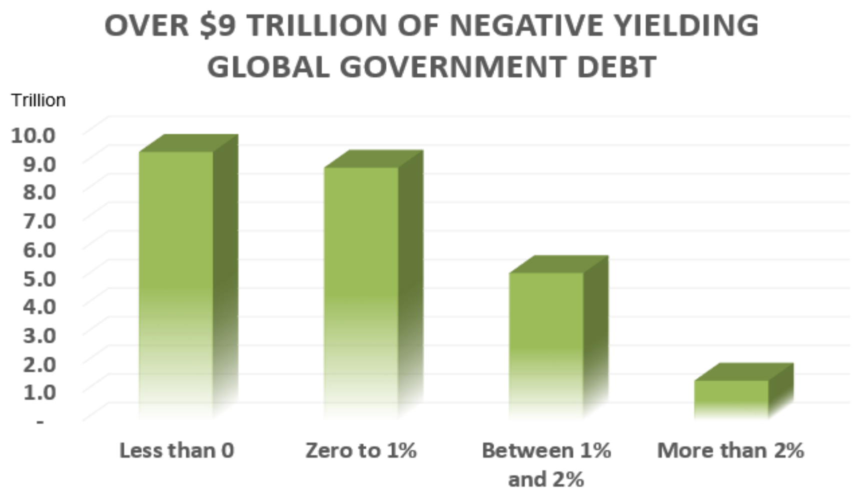
'Lower for Longer' was the title of the bond section in our Spring note and in a post Brexit world we feel it is appropriate to revisit this theme once again. In the absence of a Sterling crisis, UK interest rates are not going to go higher anytime soon. It is a risky world out there and investors are now willing to accept negative yields in return for safety. With Germany, Japan, Switzerland and Sweden forcing their yields below zero, the 10 year UK Gilt yielding just below 1% and the 10 year US Treasury yielding around 1.5% seem like attractive assets for safe haven seeking investors. Lower rates simply reflect investors' expectations of weaker growth, as well as an elevated demand for safe haven assets. Many market participants have been underweight government bonds for over 5 years now. They were expecting inflation to materialise due to excess reserves in the banking system. But here is the problem with this theory - there are no excess reserves. Due to extreme regulatory capital requirements they are now permanently embedded in the system. There is no chance of an excess credit supply in the Eurozone's bank financed economy.

The strong post-referendum performance in Emerging Markets and High Yield fixed income assets can be attributed to heightened expectations of more "easing" from central banks. Although we do like some individual high yield and Emerging market bonds we still prefer to stay away from bond index products which tend, like unitised property funds, to be quite illiquid. When illiquidity meets hot money, bad things tend to happen to investors who don't know exactly what they own.

Since April we have been adding positions in US Dollar, Australian Dollar and Canadian Dollar Index Linked Bonds. They are a small portion of our portfolios and although their very long duration makes them quite risky, the potential for losses is vastly outweighed by the possibility of explosive returns in conditions of low rates relative to inflation. These bonds might suffer more than their nominal counterparts in the event of a surprise rate rise but we think central banks will not be raising rates hard and are more likely to let inflation run in today's low growth environment. The average duration on our fixed income portfolios is between 4 and 6 years and non-sterling bonds now constitute just above 40% of the bond section of our Balanced and Growth portfolios.



Source: Bloomberg Global Developed Sovereign Bond Index

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REAL ASSETS

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All that glitters

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The definition of a mine is a hole in the ground with a liar on top. Small gold mining stocks have soared since Brexit, having already had a pretty good run this year. Even the larger ones have been spectacular. We sold Randgold Resources when it hit its 6400p upside target in February but after a slight pullback it rocketed to a post Brexit 9,820p high on 6th July. It is now settling back. This stock has large reserves, a low extraction cost and a great pipeline but at 6,400p was a long way from a bargain, even at $12.50 an ounce. We held two positions in Gold ETFs until the week before Brexit, but sold one as the odds towards a Remain vote rose. You cannot win them all. The shock pushed the price of Gold in Sterling up to a peak 20%.

Silver had an even more meteoric rise, again largely on speculative haven grounds, while base metals stabilised and industrial mining giants rallied on hopes of more stimulus. Anglo American and Glencore have led the charge and even have quite tempting prospective cash flow yields (6% and 13% respectively).

Property is at the other cycle extreme, and although respectable yields are still available in many areas in the UK, there is a question mark hanging over deal flow. Anecdotally, London is not dead post-Brexit and indeed could be seeing business as usual shortly. But there is a lot of capacity in London Residential (and more on the way), while Retail is starting to flounder in some areas. Several major REITs have ungeared balance sheets ready for opportunities and the main stress has come from funds which were unable to satisfy redemption demands and should not have been sold to retail investors anyway. In the US, institutions have low allocations to REITs, which are performing strongly.

We have reduced our property weighting and are considering taking on more commodity exposure. The chart below shows both sectors have seen better days in the last five years.

The iShares UK property ETF and Rio Tinto PLC: 2007 to 2016.

Source: Bloomberg
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