

July 2017

**SUMMER NOTE**

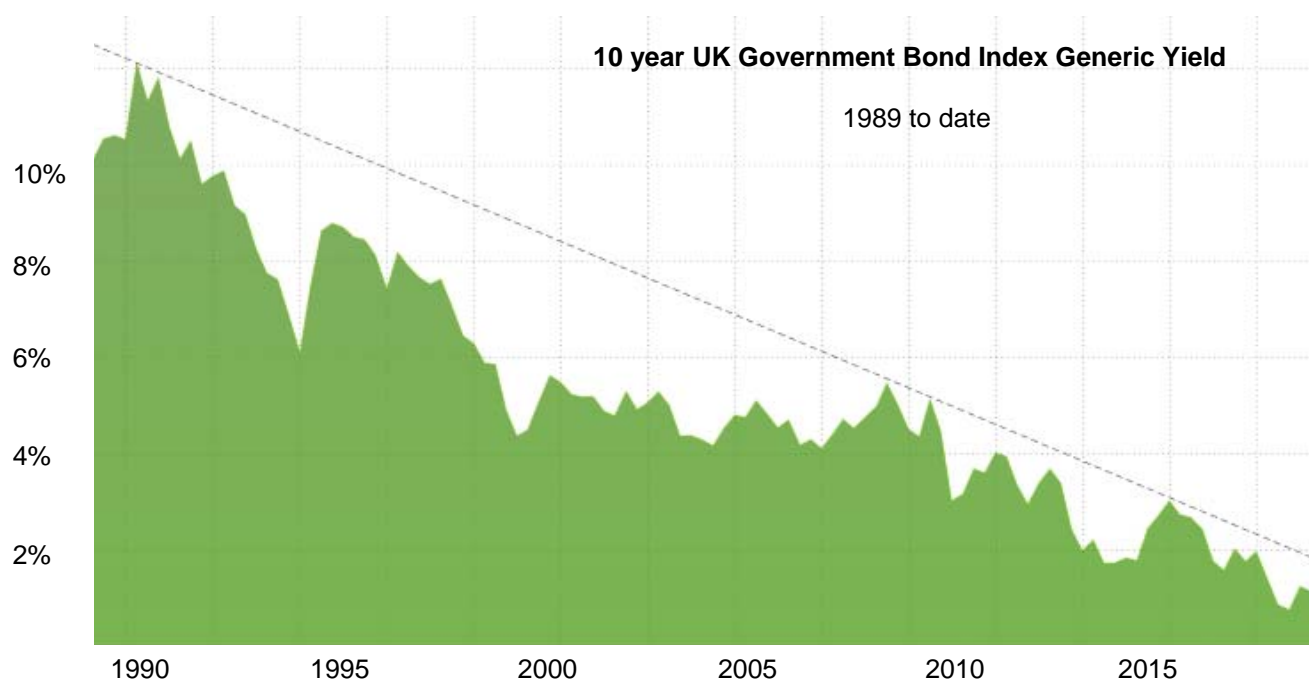
**Analysts: Giles Rowe  
 Artur Baluszynski**

# The Great Bond Mystery

While politics is very entertaining these days, the main story investment-wise is the roaring bond market and the prospect of rising interest rates. The market is worrying about the latter, but the strength and length of the US bond yield downtrend suggest stronger forces at play than official policy.

The US rate cycle is dominant, and the one we focus on in this note. The UK is also moving towards a rate tightening, which may in turn strengthen Sterling.

The chart below shows the UK's generic 10 year gilt yield. This too is in a strong down trend, and Mr Carney has to break it to force rates up. The US has demonstrated this could be harder than we might expect, and a Bloomberg survey shows markets are sceptical, with the consensus for a weaker Sterling.



Source: Bloomberg, Henderson Rowe

Enjoy your Summer, whatever currency you spend.

Artur Baluszynski  
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 CEO & CIO

BONDS

July 2017

# Rising rates?

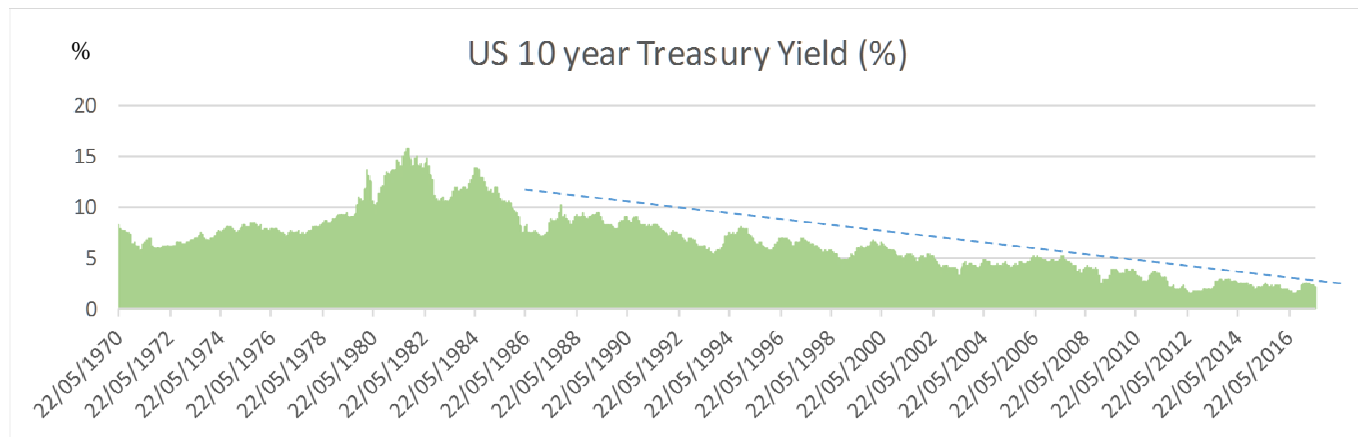
Life is increasingly painful for investors hoarding cash. As they wait for interest rates to rise before buying bonds, the bus never arrives. As the chart below shows, the long term trend remains heavily downwards. The trend goes all the way back to 1980, so it is strong and hard to shift. It hardly missed a beat even when the Fed started raising rates back in late 2015. The flip side of low bond yields is high bond prices, and the forceful trend means bond prices could still go higher despite bonds' meagre returns.

The risk that comes with rising interest rates is greater in bonds with longer maturities. If the market sees interest rates rising into the future, then the long term yield will rise, hitting longer dated bonds' prices. Conversely, when rates fall, long dated bond prices rise, which is what has been hurting cash hoarders - they have missed out on great gains!

On June 14th the Fed raised benchmark rates for the second time in three months, from 1% to 1.25%. In parallel it plans to reverse Quantitative Easing, which had left it with \$4.2 trillion Treasury bonds on its balance sheet, letting them mature. Redemptions would rise to \$50 billion a month over a year. Surely this was the time for bond prices to fall?

But what happened? US bond markets shot up as yields fell! Instead of quaking in dread of rising interest rates, 10 year Treasury yields dropped 8 basis points (1/100ths of a %, a big deal in yield terms) to 2.13%. The iShares 20+ Year Treasury ETF (TLT) rose 7.1% on the day.

Why? The markets looked at weak CPI inflation and retail sales data which suggested inflation will remain low. One theory is that digital technology impacting labour means wage inflation no longer happens at a cycle top. If so, the Fed has waited too long to raise rates and still needs to raise them to prevent asset pricing distortions. If the theory is wrong, the bus has simply been delayed again. At the end of June the market reacted at last, yields rising on 'tightening' fears. Given the harm that could happen to long bonds if the market suddenly decides we are in a high rate rise regime, we are staying with medium term corporates with reasonable credit and yield, some government bonds as buffer, and taking risk in higher yield non-US Dollar Emerging Market Debt. Despite this, we think it will be tough to raise rates hard, given the trend.



Source: Bloomberg, Henderson Rowe.

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**COMMODITIES**

July 2017

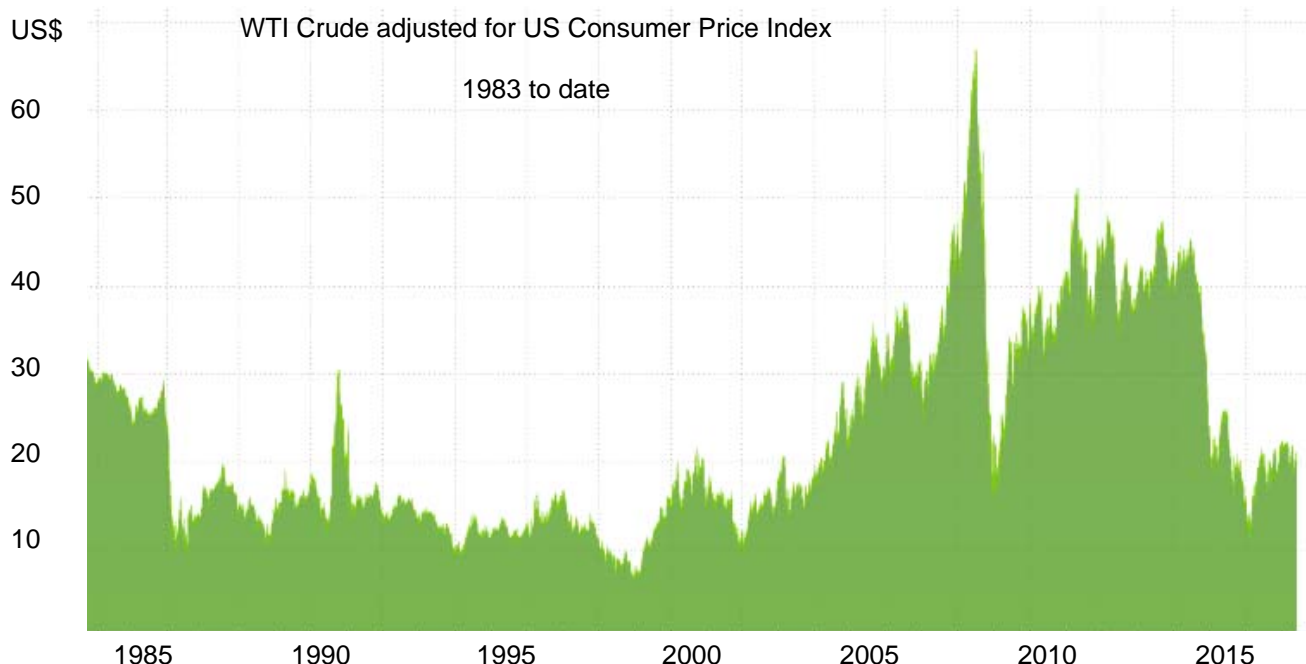
# Silver Lining

OPEC blew only itself up when it tried to punish US oil producers by ramping up production in 2014. Instead of maintaining a \$100 a barrel floor, the price dropped to \$27. Even at today's \$45 it is trading at a level which, adjusted for inflation, is below the oil price back in 1983. Technology advances mean US drillers are able to keep producing above breakeven while OPEC members with bloated budgets are bleeding red ink. The chart below suggests the heights of 2002 to 2014 were exceptional, and oil's price is returning to the long term norm.

Massive investment in capacity has led to plummeting solar and wind prices, so the pressure is on from alternative energy too. Prices are determined at the margin and OPEC, which still controls 61% of world oil supply and 80% of reserves, could squeeze them up if it ever exercises enough discipline. Meanwhile, the strong US Dollar means cheap oil is particularly beneficial to the USA, though together with low interest rates it is stimulative globally.

Demand is the other side of the equation. Iron ore prices are bouncing back from a dire quarter, and whether momentum is maintained will in part depend on how real-estate and construction react to government tightening in the second half of the year. Copper, often dubbed 'Dr Copper' because it acts as a barometer for economic activity, looks as if it is about to hit February's \$6,100 high, potentially with more to come if Chinese demand holds up.

As usual, it is easy to find something nasty in the woodshed (the current Qatar / Saudi standoff, for instance), so events can shake complacency at any time. We hold Gold and BHP Billiton, having generally found better opportunities with more control over their pricing and destiny in other areas.



Source: Bloomberg, Henderson Rowe. Chart: Baker Hughes

## EQUITIES

July 2017

# Cruising altitude

## US

Is the US economy moving into the late phase of this business cycle? The US stock market is hitting all-time highs, credit defaults are slowly edging higher from record low levels and wage inflation may pick up given unemployment is approaching 4%. This gives the FED a green light to proceed with two more hikes planned this year. There is limited amount we can read from the previous rate hikes as this time the Fed is trying to normalise the interest rate environment from a historically low level. It is no longer a simple case of trying to slow down an overheating economy but to balance a fragile, globally interconnected system still recovering from the global financial crisis. In the past, the rate cycle decision was based on a domestic US agenda, and the end of the Fed's tightening cycle would usually mean another recession and a selloff in the stock market. This time the Fed wants to hike to "normalise" and probably to give itself some room to cut interest rates if another significant downturn is to arrive.

After a very long recovery and expansion, the US economy is at its "cruising altitude". The US market is trading at a cyclically adjusted price to earnings ratio of almost 26 times, the third highest in the last 100 years. Should we sell the market and run? Sadly, no one will ring a bell at the top, and these markets can go on for much longer than most investors imagine. We will be looking closely at both credit and equity markets to give us some clues about when we are likely to land. If the Fed is behind the curve and is tightening into weakness, it might be a very bumpy ride.

## UK and Europe

The one thing which can guarantee the internally bickering continental Europe comes together is a common enemy, and since November last year, it has two. First came Brexit, then the Euro bashing President Trump. Any hopes for Eurosceptics gaining power in Europe have been put to bed during the Dutch and French elections. The 28 EU members have already agreed on a common strategy for Brexit negotiations, while the UK is in the midst of a political crisis. Euro-area economic confidence has just hit the highest level in a decade according to Bloomberg, and the ECB has been signalling readiness for unwinding its stimulus since mid June. We like European markets and have recently decided to increase our exposure. Relative to the US, Europe offers cheaper growth stories and good exposure to domestic and international consumers as well as industrial businesses exposed to Asian economies. The obvious risk is that most of the positives mentioned above have already been priced in.

The UK has had a very volatile two and a half years. First the commodity sell off in 2015, followed by Brexit last year and a confusing general election in June 2017. Yet the FTSE 100 and FTSE 250 have managed to record double-digit gains. As many constituents in both indices are "dollar earners" the weakness in Sterling has boosted their revenues. The FTSE All Share Bank Index tells a different story. The index is down 6% since mid-2014 signalling a potential storm on the horizon. The market may be telling us that after seven years of growth, the UK property market could be about to stall, putting pressure on consumer spending and the UK banking system.

## EQUITIES

July 2017

## Cruising altitude (Cont'd)

But it is not all doom and gloom in a post-Brexit UK economy. Lending growth has picked up recently, and the average UK bank capital ratio is three times higher than in 2007. The FTSE All Share is trading at a 6.6% earnings yield, a better alternative than London property and non-existent interest on bank deposits.

### Asia and Emerging Markets

Four years into Abenomics and after a short recession in 2014, the Japanese economy is picking up supported by fiscal stimulus and negative interest rates. Inflation started creeping higher due to an 11% drop in the Yen-US Dollar exchange rate, but is still below the Bank of Japan's 2% target. However, Abe has failed to deliver any significant progress on the most important "third arrow" of his long-term plan including reforms to the Japanese labour market and a more open immigration policy.

Commodity exporting Emerging Markets like Russia or Brazil are still at the mercy of energy and basic material prices. After two years of recession, both economies seem to be slowly stabilising, but their stock markets remain closely correlated to commodity prices. Although these markets look cheap in comparison to other regions, in reality they are trading at or around their historical average Price to Earnings ratios. We are underweight equities in these regions.

Other developing economies, particularly in Asia, should benefit from Chinese growth supported by abundant liquidity. We would expect the 19<sup>th</sup> National Congress of the Communist Party, planned for this Autumn, to be a catalyst for further efforts in re-balancing China towards a consumer based economy. The major long-term risk is China's reliance on credit and murky shadow banking products.

Source: Bloomberg, Henderson Rowe.

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**EQUITIES**

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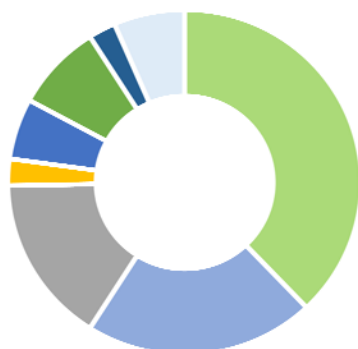
# Henderson Rowe Model Portfolios

## Current Asset Allocation

We have recently increased our exposure to Continental Europe at the expense of the UK Mid Cap segment. We are underweight the US vs. our GDP benchmark, mainly because of stretched valuations. There has been no change in our exposure to Emerging Markets since the last note. We are still finding more value in Developed Markets than the Emerging World, primarily due to issues around access to reliable information and attitudes towards shareholder's rights.

Asset class	Domestic	Semi International	Global
UK	91.0%	33.7%	9.0%
North America	0.0%	21.4%	30.1%
Europe ex UK	0.0%	22.6%	31.0%
Developed Asia Pac	0.0%	2.6%	2.6%
Japan	0.0%	2.8%	8.6%
Emerging	0.0%	7.9%	9.5%
Real Estate	2.5%	2.5%	2.5%
Commodities	6.5%	6.5%	6.5%
Equities	91%	91%	91%
Real Assets	9%	9%	9%

Henderson Rowe Semi International Equity Asset Allocation



Henderson Rowe Global Equity Asset Allocation



Source: Bloomberg, Henderson Rowe.

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