HENDERSON ROWE

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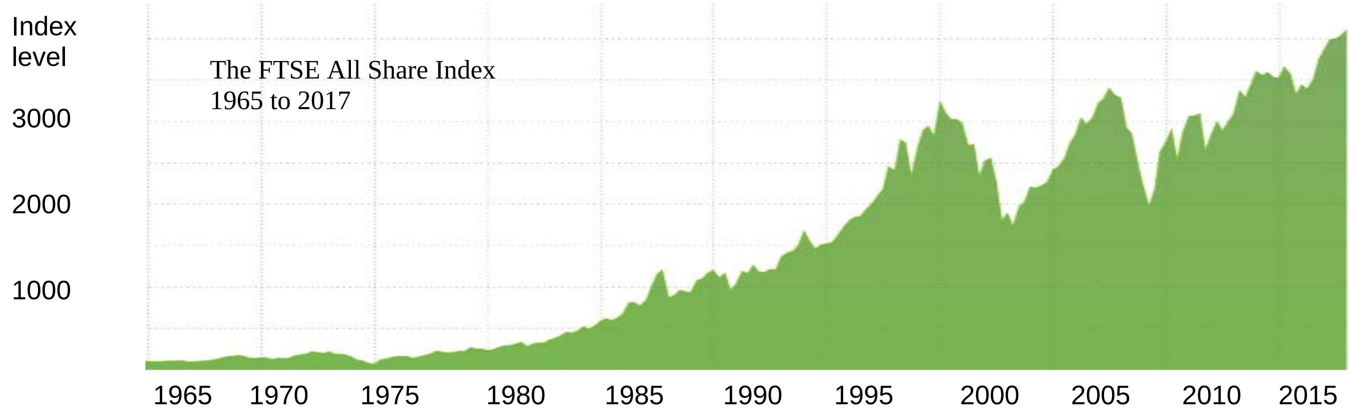
AUTUMN NOTE

Megatrend?

Bulls have been enjoying the ride for several years, barely interrupted. There can be little doubt the rise in equity markets has been in lock-step with central bank policies which have reduced interest rates as the likes of the Fed, Bank of England and ECB hoovered up bonds and other financial assets. The reduction in rates began long before the 2008 crash, as the collapse of Communism coincided with the acceleration of globalisation. Fundamental trends are difficult to change and we will soon see if policymakers are able to reverse the rate decline, or whether it results from deeper factors.

In the UK a token interest rate rise has come as CPI inflation hits 3%. The first in ten years, it will be heralded as a major signal, but more are unlikely while growth and wages remain subdued. For real growth we need to look at the US as tax reforms come nearer. Annualised 3Q 2017 GDP growth in the US was 3%, against 2.2% expectations[1], the level now reached by the EU[2]. China's growth[3] is bouncing around just below 7%, enough to double GDP in 10 years. There seems to be a synchronized global growth tailwind gathering, led by the US. Yellen's Fed ended large-scale asset purchases, given interest rates a lift-off from zero and pulled back from an unprecedented balance-sheet build-up without hurting markets or the economy. Quite a feat, and paving the way for others central banks, and her successor, to follow.

Markets look high. But as currency traders will tell you, it is seldom wise to bet against central banks. They remain engaged in supporting global markets, despite taking their feet off the gas and gently raising rates. With the right mix of inflation and growth, ring fenced banks and fiscal stimuli, permabears could still face a few more years of pain.



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Sources

[1] Bloomberg US GDP Economic Forecast QoQ% 30th October 2011
[2] Bloomberg EU GDP Chained YoY 30th October 2017
[3] Bloomberg China GDP Constant Price YoY 30th October 2017
[4] CFRA and S&P Dow Jones Indices, AAII

Chart: Bloomberg

The Climb

US

As US equity markets continue to climb, a lack of optimism about the outlook for returns continues to dominate headlines. The S&P 500 index is up over 11% year-to-date, the economic expansion and the bull market are now entering their 8th year. Many market commentators are worried as cycles usually do not last this long. Obviously, this cannot go on forever and at some point the cycle will turn. For now, the economy seems to be improving, wages are picking up, and the yield curve has not started inverting yet.

The September hike planned by the Federal Reserve was a no-go due to hurricanes Harvey and Irma[1]. But 3Q GDP advanced 3% despite them[2], with positive effects expected from the clean-up and the rebuilding, later in the year.

The better than expected performance of the US economy also helped the market to shake off Trump's failure to get any of his major initiatives passed through Congress. Bloomberg consensus GDP growth for 2018 is 2.4%, but with a reasonable prospect of tax reform and deregulation at the administrative level, we could potentially see this cycle running even further. However, the markets are trading at quite extended valuations and with expectations elevated, are vulnerable to disappointment. Policy mistakes from the Fed remain a short-term risk.

The S&P 500 is trading at 20x Bloomberg consensus 2018 earnings and has a 4.2% free cash flow yield. The Shiller CAPE (Cyclically Adjusted PE Ratio) is 31x vs an average of 16x. But these ratios are high because Shiller uses a ten year average, and the ratio will fall as the low profits of the 2007-9 Great Recession roll off.

UK

The Bank of England's Monetary Policy Committee (MPC) has recently taken a more hawkish tone[3] over UK inflation. Mark Carney is now expected to raise interest rates to 0.5% before the end of 2017. According to EY[4], the consumer sector remains under the most pressure with rising inflation, low wage rises, welfare cuts and a slow housing market all acting as drags on spending. We would expect the BoE to take a "wait and see" approach after its potential hike in November.

The Pound's daily volatility remains closely linked to UK politics. The currency has gained around 8% since its post Brexit low point of $1.21 but remains 12% lower since June 2016. The recent 4.8% gain after Mrs May's Florence speech in September has been wiped out after her questionable performance during the Conservative party conference in October. One would not be blamed for confusing Sterling with an Emerging Market currency just by looking at its chart. While the costs and benefits of Brexit lie very much in the eye of the beholder, what matters for investors in either camp is the uncertainty.

Sources

[1] FOMC statement 25th October 2017
[2] Wall Street Journal 27th October 2017 'US economy notches solid 3% growth despite hurricanes'
[3] Bank of England Monetary Policy Committee minutes 13th September 2017.
[4] Ernst & Young Item Club UK Outlook September 2017

The Climb (Cont'd)

The Tory party conference in October showed just how divided the party is on Brexit and that there is no clear strategy in place. German's heavy-machinery association has recently warned against a disruptive divorce from the European Union[1]. The UK is the industry's fourth-largest destination, and it obviously wants to continue their very close relations. But they will not wait forever. If there is no real progress in negotiations, developing new business within the EU will become their priority. A no-deal scenario, which Rabobank says could hit the UK's GDP by 5% to 7% in the medium - term, could now spark a real risk of a run on the Pound.

While we are still patient and optimistic about the long-term prospects for the UK economy, we will be reviewing our exposure to the UK domestic sectors if the "no-deal" scenario looks like the most likely outcome.

Europe

The Euro has appreciated over 10% against the US Dollar during the course of 2017. While for some companies it could be a cause for concern, it is a testament to Europe's ongoing economic recovery. Around 40% of European businesses derive their earnings from overseas markets, and a stronger currency might come at the price of weaker margins. However, domestic businesses, financial institutions and households should find their fundamentals improving. Economic growth has continued to surprise over the last quarter, and unemployment has trended lower into single digits. Last month, the ECB raised its 2017 economic growth forecast for the Euro to over 2%, putting it on track for the strongest growth in 10 years. This "Goldilocks" combination of improving macroeconomic and political sentiment has fuelled M&A activity, which according to Lazards[3], has already eclipsed that of the United States. According to JP Morgan Research[4], real GDP has been running above trend for 13 quarters now, and the recovery within the Eurozone appears to be synchronised, with all the key countries growing above trend.

The main risks include the ECB tightening too soon, an unexpected slowdown in Asian or US demand for European goods as well as the political situation in Southern Europe.

Core European indices are trading at around 15x next year's earnings and have a 9% free cash flow yield.

Sources

1. Bloomberg News: 9th October 2017 'German industry group becomes second to warn against hard Brexit'
2. Rabobank: quoted on 11th October 2017 in The Independent
3. Lazards: Outlook on Europe October 2017
4. JP Morgan: Equity strategy 25th October 2017

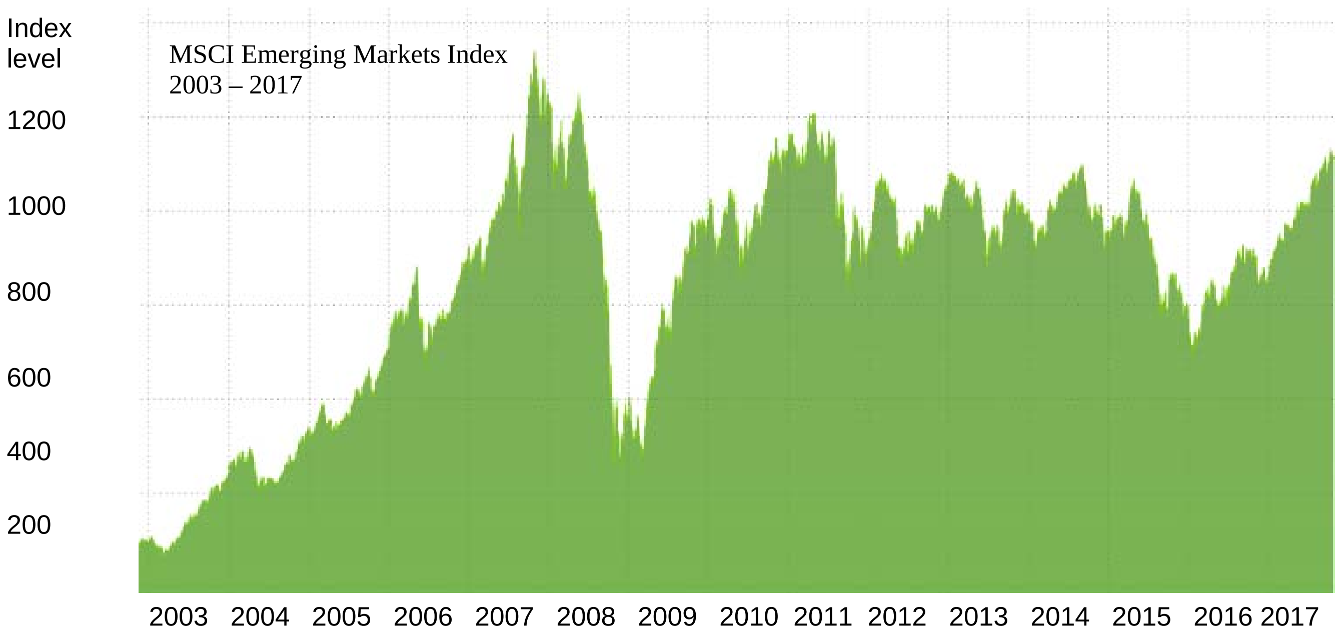
The Climb (Cont'd)

Asia Pac and Emerging Markets

Emerging market equities have benefited from yield-seeking in a low-rate world with the MSCI EM Index returning around 30% year to date. At 15x times next year's Bloomberg consensus earnings, developing countries offer growing earnings growth, improving ROEs, and slightly higher dividend yields compared to developed markets. China's 19th Communist Party Congress, which convened in October, has further consolidated President Xi Jinping's authority. The Communist Party and the President will continue to implement market and domestic reforms with a focus on improving the country's financial stability and social welfare. The rapid increase in debt, widespread securitization, and the poor transparency of China's banking system are causes for concern. China's debt growth, which has pushed debt to GDP to almost 300%, will need to slow at some point, potentially reducing global and domestic demand.

Japanese corporates recorded a 21% rise in profits through higher margins during the second quarter as economic data continues to surprise on the upside. The US and China's PMIs are both in expansionary mode which is usually a good indicator for growing global demand and a boost for Japanese industrial exports. However, the ongoing issue with North Korea has presented Mr Abe with his first real test in the geopolitics of the region. Military risks aside, the weakening Yen and tech stocks are underpinning Japan's rally.

The key risks for Asia Pac and the Emerging markets include Chinese debt, resurgent populism, North Korea, and deepening recession and political crises in countries like Brazil and Venezuela.



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BONDS

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All together now!

Most developed countries are keeping their monetary policy deliberately accommodative while carefully watching inflation approaching their targets. After a swift bounce in commodity markets, fixed-income investors are getting nervous. Bond pricing in many developed world markets leaves very little room for error. Any meaningful rise in future inflation expectations may lead to an abrupt repricing and losses for unprepared investors.

In the near term, the Federal Reserve is expected to raise rates in December, supported by higher growth and inflation. The first into quantitative easing, the US is also the first out. Although we do not expect a sharp sell-off in US Treasuries and other fixed-income assets, we are positioned defensively and favour short duration securities. As long as corporate profitability remains good, high yield bonds should continue to perform, although a 1% default rate is quite indicative of a cycle top.

The risk faced by the Fed, the ECB and the BoE as they begin raising interest rates and cutting back stimulus in a short space of time is triggering a simultaneous sell-off in major developed bond markets. Although not a high probability event it needs to be taken into consideration when constructing fixed income portfolios. We hold very little exposure to € bond markets and are watching our holding of UK Fixed and Inflation-Linked Gilts. We have recently added some exposure to Emerging Markets Local Government Bonds, whose higher yields should cushion some of the interest rate related risk.

The long-term downward trend in yield in US Treasuries remains intact, and as per our previous note, we are not prepared to dramatically reduce our fixed income allocation until we think this trend can show a meaningful reversal.

US 10 year Treasury Yield

Source: Bloomberg, Henderson Rowe.
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Renewables vs. Big Oil

Saudi Aramco's planned Initial Public Offering is expected to raise $100 billion[1] from the sale of a 5% stake. After some doubts around the valuation and criticism of Aramco's ability to comply with US or UK regulations, the world's largest oil company is now aiming to list in 2019. With existing upstream capacity to produce over 12 million barrels per day of crude, Aramco is bigger than Exxon, BP and Shell combined. Aramco also claims around 260 billion barrels of proven reserves[2], nearly a sixth of the world's reachable oil. But Saudi Arabia has a problem: US shale oil producers are not part of the OPEC cartel and therefore are not bound by any planned and announced cuts to production. The Kingdom cannot afford a slide in oil prices as this would jeopardise the success of the IPO. Oil prices must be seen as strong if Aramco is to be valued anywhere close to the figure claimed by the Saudi government. By putting Aramco up for sale, the Kingdom of Saudi Arabia limited its ability to "fight" US shale producers with low oil prices. It needs the price of oil to be cheap enough to maintain its market share and strong enough to make Aramco worth what they claim it is worth. In our opinion, this should translate to quite stable, sideways moving energy markets over the short term.

The UK's renewable energy industry[3] recorded its highest ever output in June 2017 as wind turbines, and solar panels produced a combined 17.1 Gigawatts (GW). Including Hydro and Biomass, the combined output reached 19.3 GW, more than 50% of midday power demand in summer this year. Historically, renewables' investment opportunities have been limited to Private Equity vehicles, dominated by institutional money, or questionable "tax avoidance" schemes, often sold to unsuspecting retail investors. Since the financial crisis, low-interest rates, technology progress and low manufacturing costs in Asia has allowed solar panels and wind turbines to penetrate the mainstream energy market. A big push from Infrastructure specialists, lobby groups and political initiatives like the Paris Agreement has created enough momentum for public equity markets to get interested in the renewable energy space. Solar and Wind energy markets still rely on subsidies from governments, but so did oil companies during the oil boom in the US at the beginning of 19th century. According to Bloomberg in 2016 the investment in renewable energy capacity outstripped that in fossil fuel generation for the fifth year in a row. Excluding large hydro, some 138 GW of new power capacity came online. This is almost 11 gigawatts more than in the previous 12 months. Also, the cost of achieving this was 23% lower than in 2015. Issuance of so-called "Green Bonds" in China reached $27.1bn in 2016, overtaking $15.5bn in the US. Although fossil fuels remain the main source of energy for most of our daily consumption, easy access to capital and a growing appetite from investors should translate into strong growth in renewables in the long-term.

Although we do not see ourselves making a substantial shift in our asset allocation into renewables, we have recently made some investments in infrastructure businesses with long-term inflation-linked contracts as well as specialised equipment producers with strong market positions. We will be watching this space closely and take advantage if we see any opportunities meeting our investment criteria.

Sources

1. *Forbes: 5 ways a Saudi Aramco IPO could play out. 22nd October 2017*
2. *Saudi Aramco Annual Review 2016, 6th July 2017.*
3. *Bloomberg 'Global trends in renewable energy investment 2017: New energy finance' 2017*

EQUITIES

November 2017

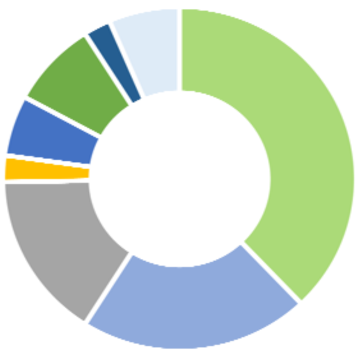
Henderson Rowe Model Portfolios

Current Equity Asset Allocation

We have recently increased our exposure to Real Assets on the back of inflation surprising on the upside. We are overweight Europe and 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. Our Equity to Bond balances remain unchanged across strategies (not shown here).

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%	2.7%
Japan	0.0%	2.8%	8.6%
Emerging	0.0%	7.9%	9.5%
Real Estate	2.5%	5.5%	5.5%
Commodities	6.5%	5.5%	5.5%
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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