



## Investment Letter – Q4 2016

After what has been a 12 month rollercoaster ride, we felt it was worth looking back at the year as a whole. 2016 began with a crash, as markets came to terms with the much heralded rate rise in the US, Chinese currency devaluation, and impending EU Referendum-related furore. Fears of a second European banking crisis in under a decade were fuelled by Deutsche Bank's oversized debt position, as its share price fell to a thirty-year low in the first few weeks of the year. By February, equity markets had hit their trough for the year, with oil at a 12-year low of \$26 a barrel. Safe-haven assets like government bonds soared in price, meaning that their yields fell to their lowest on record; gold had its best quarter since 1986. And yet, despite this, by the end of the first quarter equity markets had all but recovered.

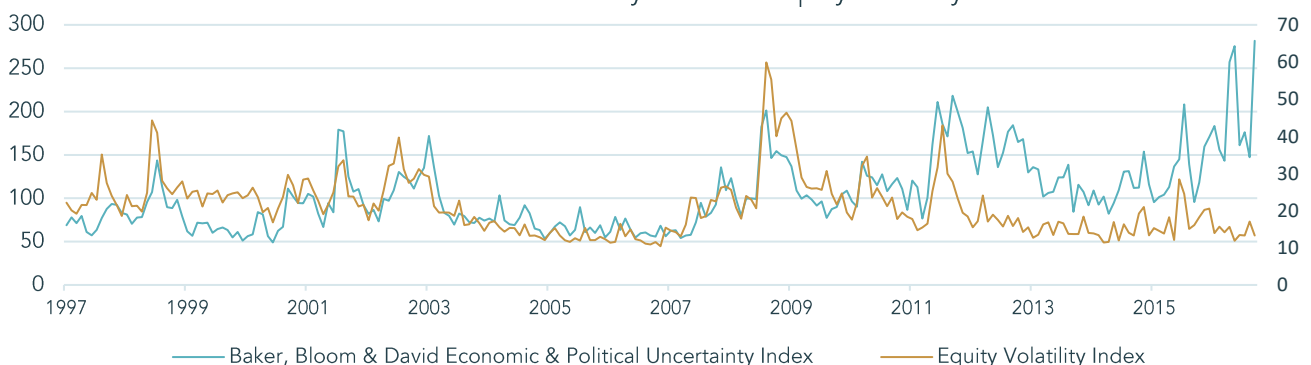
As investors sought to forget the first quarter's setbacks, all eyes turned to the UK's Referendum in June. The 'Leave' vote, while a shock to the establishment, marked the first clear sign of the growing discontent at the lack of palpable economic progress among the wider population in the developed world, and set the tone for the rest of the year's political events. The day of the result saw markets open in turmoil – the FTSE 100 started the day down over 7%, with the S&P 500 and the Eurostoxx 50 following a similar pattern. By the end of the day, however, the UK market was back on its feet, having recovered almost 6%. In fact, just over a month after the result, the FTSE 100's year-to-date performance was nearly 8%, as UK multinational companies benefitted from increased exporting competitiveness following Sterling's massive depreciation.

With the FTSE 100 soaring, markets turned their attention to the US election. In the run up to the election there were some odd market moves. October saw substantial moves in foreign exchange markets – unusual given the perceived better liquidity of these markets (meaning that they should be less susceptible to these sorts of moves under normal market conditions). UK government bonds suffered some wild movements, with prices falling sharply and yields rising rapidly. The most widely discussed bond, the 10-Year US Treasury, fell in capital value by nearly 4% in the first two weeks of November – the equivalent of almost 2 years of income. And European banks were back on the radar; their continued poor performance and the increased perception that they were no longer safe places to do business led to further falls in their share prices.

Donald Trump and Hillary Clinton are likely to go down in history as the two most disliked US Presidential candidates of all time, with a new scandal about one, the other, or both erupting in the press every other day. Many underestimated Trump's ability to win, but it was in the end the same anti-establishment feeling behind the UK's Leave vote that set the stage for his victory. With the post-Brexit market recovery still firmly in investors' minds, the much expected market turmoil was over almost before the markets were able to register the news – unless you were trading out of Tokyo, where Japanese equity markets fell almost 10% before recovering the next trading day. Since the election equity markets have rallied strongly, with smaller, domestic companies in the US a particular beneficiary of the result. However, Trump's victory cemented the start of the global selloff in government bonds, as investors focused on an end to loose monetary policy over his term.

And so 2016 came to a close, with the FTSE 100 and S&P 500 near all-time highs – quite surprising, given political instability also hit new heights at the same time. While putting an exact number on something as intangible as political sentiment is a tall order, three American economists have given it a go, putting together a now well-respected index to measure Economic and Political Uncertainty. The chart below shows the index at an all-time high; this measure of increased nervousness doesn't sit well with equity market volatility at historically low levels. We continue to believe that the easy monetary policy that we have experienced has "numbed" normal market reactions to these types of signals.

Economic & Political Uncertainty Index vs. Equity Volatility





Looking ahead to next year, we see a number of key themes continuing to play out. Our long-held underweight in conventional fixed income investments may finally be coming good, as the era of low interest rates looks to be at an end. While US Treasuries have sold off already, there is still a long way to go in other parts of the developed world; despite political machinations, European government bonds still show little discernible upside, and pay little to no income relative to the risks inherent in holding these sorts of investments. We maintain an underweight and alternative stance in fixed income asset classes. In the topsy-turvy world where investors buy bonds for capital gains, and equities for income, we would rather miss out on some potential gains than suffer the inevitable losses of the reversal of this trend.

We continue to favour developing and emerging markets over developed market equities. In the developed world, conventional monetary policy tools appear to have failed to stimulate growth, while encouraging investors into riskier assets and further exacerbating the debt burden. PMIs (a measure of economic activity) are barely above the level that indicates progress in the economy, while there are few signs of meaningful GDP growth or inflation in much of the developed world. Consumers are continuing to hoard cash, with personal deposits in the developed world growing strongly as many attempt to protect against perceived and actual economic uncertainties. With a number of elections on the cards in Europe in 2017, support for extreme views is becoming stronger. The perception that globalisation has failed continues to grow. Concerns over job security, either through immigration or through the exporting of the same job to an economy that can produce more cheaply, exacerbates the difference between those that have benefitted from the move to a service-based economy and those that have lost as much from the demise of the production economy.

In the US, investor confidence was at a nine year high following the election of Donald Trump; the last time it was this high was in January 2007. In our view, however, this optimism may be overdone. There remains a huge amount of exuberance in developed equity markets. Having already put together a cabinet of his peers – 17 of which have a greater combined net worth than the bottom 43 million US households combined – Trump's first moves as President will be scrutinised closely. The difference between the expectations of the market and the likely reality – particularly with regard to Trump's ability to borrow more, lower taxes, and ramp up infrastructure spending in the current environment – make for a worrying outlook for developed market equities next year. We are underweight most developed equity markets, which we see as overvalued and facing major economic and increasing political headwinds.

In contrast, Asian and Emerging markets look relatively attractive. Led by structural growth markets like India and China, these countries are taking fundamental steps to improve their economies through reform. Valuations are more interesting, and these economies have, in many cases, a huge amount of monetary policy fire power left to help stimulate their economies should they require it. Developing market equities pay a sizeable dividend, while their government bonds offer an attractive yield – one that is genuinely reflective of the risks of investing in these instruments without the distorting effects of central bank intervention. Of course, these areas of the world are prone to bouts of considerable volatility; active management and careful investment selection remain the key to investing in these areas.

Contrary to our core view is Japan, a developed market where we remain confident for the equity markets. In 2015, the weaker yen and stronger demand from the US, Europe and Asia was a major benefit to Japanese equities. However, 2016 saw huge flows into the currency as investors sought out the traditional 'safe haven' asset during market turbulence in the first quarter. The strong Yen was a problem for Japanese equities, many of which are exporters. However, this period of Yen strength looks set to change: the Central Bank's latest alternative policy tool involves pegging the 10 year government bond yield to 0%. As bond yields around the world have risen in the second half of this year, the Bank of Japan has been forced to unleash massive quantitative easing to hold the yield stable, significantly weakening the yen. With the short term currency headwind removed, we continue to feel very positive about Japan over the long term, as corporate sector reforms have fundamentally changed the mind-set of Japanese executives towards their shareholders.

We have positioned ourselves to participate as much as possible in any further market strength but we firmly believe that the risks in the near term are skewed to the downside, with the market ignoring what in previous cycles would have been considered to be significant risks. We still hold a reasonable cash position, along with an exposure to gold. Our intention is to look for better entry points; this may come with an improved outlook, or it may come with better valuation levels. Whichever it is, we will remain patient and look for opportunities to deploy the capital we have on the side-lines effectively.

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