

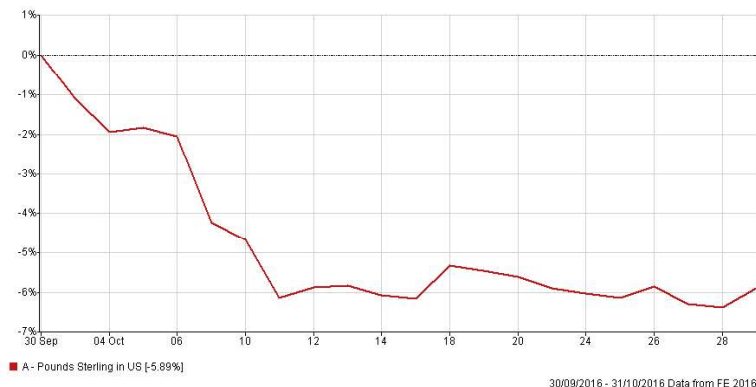
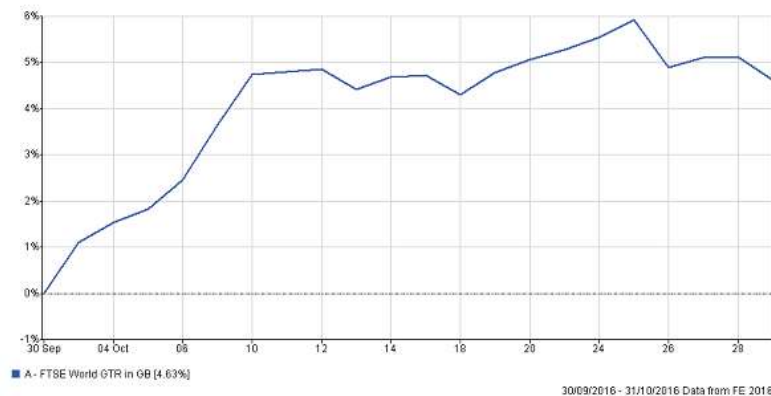


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POINTS OF VIEW

# MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

The FTSE World returned a little under 5% during the month of October. However, as has become a regular occurrence since the UK's decision to leave the EU, currency devaluation was the primary driver of returns for UK investors. Versus the US Dollar, Sterling lost around 6% during the past month – essentially all in the first 10 days – amid worries of a 'hard Brexit'.



## United Kingdom

In what is likely to be a long running saga, discussions around the conditions of the UK's exit from the EU continue; with a 'hard' exit outcome beginning to take centre stage. Are concerns over Theresa May's negotiations beginning to impact the Bond prices as well as currency? Gilt yields have climbed steeply during the month, with the 10 year Gilt yield now at around 1.25%. Whether sentiment for the asset class has officially changed or not is a question investors continue to deliberate over. While the FTSE 100 continues to benefit from the depreciation in Sterling (up 13.72% for the month), domestic companies are feeling the ill-sentiment directed at potentially isolated economy. The net effect for the FTSE All Share during October was a modest gain of 0.56%.

## United States

Is there to be a final twist in the election race? A week ago a Clinton win seemed a certainty, following the last in a fairly long line of Trump misdemeanours that have come to light, but the FBI reopening their enquiries into her email use may have put a real dent in her campaign at just the wrong time.

Brexit was a lesson to many about the perils of trying to predict politics. It will be interesting to see how the markets will react to either victor, and how the outcome may impact the much anticipated December rate rise from the FED.

The FTSE USA fell around 2% in Dollar terms during October. Given the close race and dislike towards both nominees, it's hard to ascertain exactly what the market is pricing in.

## Europe

Draghi confirmed that the ECB's bond buying programme is unlikely to stop anytime soon, although without providing the further clarity many had hoped for. It appears QE will run beyond the March 2017 end date; tapered or not. Given Eurozone interest rates are at -0.4% and inflation is still a long way short of the 2% target, an end to QE is hard to imagine in the near future.

European markets returned 3.7% for investors during October on the back of some generally positive economic data while the Euro fell 2.39% against the Dollar.

## Japan

Following the previous month's announcement of the new yield curve control strategy, Japan returned 8% through October (5.33% in local currency). Headline inflation remains unchanged with a year-on-year drop of 0.5%. Even taking out more volatile energy and food prices – a measure known as "core core" inflation – only brings the figure up to zero, still a long way off the 2% target.

The BoJ may, however, look at the improving unemployment rate as a sign of policy success. Whether this can feed through and stimulate the stagnant economy remains to be seen.

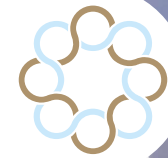
## Emerging Markets

October was another strong month for Emerging Markets, up 7.85%. The outcome of the US presidential election

will be important for the asset class, as will the speed of potential monetary policy tightening by the FED. While a Trump presidency may reduce the odds of a rate hike, his protectionist agenda is sure to be seen as a big headwind given the current exposure to US trade.

\* All performance data quoted in this article is derived from FE Analytics

First published on 3rd November 2016 by Simon Brett of Parmenion Investment Management.





# THE AFTERMATH OF THE VOTE

**The EU referendum result will be remembered as one of those defining moments in the history of the United Kingdom. In the immediate aftermath of the vote, the UK was beset by a feeling of uncertainty: over its future relationship with the EU, the economic consequences of withdrawal, the domestic political consequences, the implications for the EU itself, and, of course, the outlook for financial markets.**

## **Equities and Portfolio Strategy**

By Kieron Launder, Head of Investment Strategy, Cazenove Capital.

The 'before, during and after' periods of the Brexit vote reminded investors of some key investment tenets in terms of market behaviour. The 'no' vote had been forecasted by polls and resulted in currencies (sterling in particular), appreciating in the immediate run up to the referendum.

Given the binomial outcome of the referendum, markets were always likely to see some post-result movement, however given the conviction, and more importantly positioning of the market towards a 'no' vote, the unexpected result led to some sizeable moves. This is a clear reminder that initial investor sentiment and positioning can have a significant bearing on the ultimate performance of investments.

During the following days after the Brexit decision, we saw some considerable movement in sterling, equities and fixed income, some of which was logical and predictable, and others that did not appear to be at first. With the only short-term certainty being uncertainty it is not surprising that sterling depreciated, losing almost 12% in the first two days (after which it oscillated but stayed around the same level).

This immediate correction was also exhibited in UK equities with the FTSE 100 falling almost 6% over the same two days, until more rational investors interpreted the double-digit fall in sterling as being very positive for companies' overseas earnings, which account for about 70% of the total. As such the FTSE 100 rallied strongly, rising above the pre-Brexit level within the subsequent two days before rising further still.

For investors, understanding the true return drivers of investments is critical, as is building more multidimensional diversification into portfolios (for example not just the top-down allocation to fixed income, equity and alternatives). Many UK investors have been very pleasantly surprised by the benefit of having international exposure, (both direct and indirect) in their portfolios.

*"Markets were always likely to see some post-result movement."*

In the subsequent days after Brexit, there was a huge increase of volatility in equity markets, and significant dispersion of sectors and styles leading to potential opportunities that

normally accompany volatility. However, due to the surprise outcome and existing investor positioning, the explosive reaction led not only to over-reaction, but also illogical sell-offs where broad indiscriminate selling punished companies that should have been less affected.

Defensive stock became even more expensive and cyclical stocks and financial companies were immediately punished, although most of this has subsequently unwound. The more domestically oriented medium and small company indices suffered significantly and whilst they have lagged compared to the large-cap companies, year-to-date they are still positive for the year and more recently have been catching up. We should remember that volatility, for longer-term investors, provides potential opportunity as not everything is treated equally or logically.

### **Fixed Income**

Alex Smitten, Head of Fixed Income, Cazenove Capital

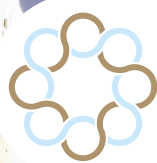
Large market movements occurred in the immediate aftermath of the vote. Firstly, as Kieron mentioned, sterling depreciated by around 12% against the US dollar, as investors discounted potential capital outflows and a likely easing in monetary policy to support an expected weaker growth outlook. Secondly, gilt yields fell sharply to reflect the likely lower path of interest rates. Finally, corporate bond risk premia rose as investors shied away from more risky assets. So far, so sensible.

The interesting thing about the corporate bond market (and other risk markets) was just how short lived the sell-off was. It essentially lasted a week, and within three weeks it was back to where it was. Not for the first time, markets were reacting to changing expectations of central bank policy. The European Central Bank (ECB) had just started buying euro denominated corporate bonds, and the Bank of England (BoE) had injected liquidity into the banking system and hinted strongly at easier monetary policy to come. It delivered in August with a cut in bank rate and another round of gilt and corporate bond purchases. Furthermore, the Federal Reserve (the Fed) had appeared to be shying away from tightening monetary policy and this prompted another wide scale hunt for yield. This has been a powerful driver of asset markets for the last few years as central banks have pushed official interest rates and government bond yields ever lower.

We now find ourselves in a position where the absolute yields of most developed world bonds are exceptionally low and offer increasingly less buffer against rising yields or risk premia. Indeed 38% of developed world government bond markets yield below zero. Even companies have been able to issue bonds with a negative yield in some currencies. Legendary bond investor Bill Gross goes as far as saying that "negative yielding bonds should be viewed as liabilities not assets"!

To illustrate why this situation is potentially so dangerous for investors, consider that since starting to write this article 24 hours ago, the yield on 50 year gilts has risen from 1.18% to





1.37%. If that does not sound like much of a move, consider that the bond's price fell nearly 6% or equivalent to five years of income! In other words, with such low levels of yield, the balance of risk and return has shifted dramatically against the buyer. As investors have tried to mitigate this they have been tempted into longer maturities and more risky bonds (for example, emerging markets) than perhaps they would normally consider appropriate. We should be prepared for some more volatile times ahead particularly if central banks signal that they have reached the end of the quantitative easing road.

### **Real Estate**

Tom Dorey, Head of Real Estate Product, UK, Schrodgers

The knee-jerk reaction of investors in daily dealing commercial property funds was to rush to the exit in the days following the referendum. The subsequent fund suspensions, coupled with sharp pricing changes have called into question the suitability of these vehicles for property investment.

The actions of retail investors have contrasted sharply with institutional investors who have remained unmoved. Why is this and what are the options?

Commercial property should be considered as a strategic investment whose returns are driven primarily by income and income growth. Institutions with a medium-to-long-term time horizon (a group that includes families), understand that the cost of buying and selling real estate is high and

that the benefits of owning it are best obtained through buying and holding. While the outlook for the UK economy is uncertain, with gilt and cash yields at record low levels, the average rental yield of UK commercial real estate of 5% looks a compelling entry point, rather than a reason to exit. Anecdotally we have continued to see good interest from retail, office and industrial occupiers over the summer, including the giant office letting we completed on behalf of Schroder UK Real Estate Fund to HM Revenue & Customs in Croydon. Long-term investors know that sustainable rental income is the key to good long-term returns – and on the evidence to date it is business as usual.

So for real estate investors with a need for genuine liquidity, there are two main options. The first is listed property investment trusts. These are structured as companies that invest directly into UK or European real estate. Due to investment trusts being listed on the London Stock Exchange, their shares are tradable daily and are not subject to fund suspensions. The second is an extension of this: investment into a portfolio of listed real estate investment trusts and other real estate securities, typically globally. Mutual funds with this objective provide both diversification and liquidity.

"Long-term investors know that sustainable rental income is the key to good long-term returns - and on the evidence to date it is business as usual."

First published on 10th October 2016 by Cazenove Capital Management.

# PENSION FREEDOM, OR PENSION PARALYSIS?

**Until the so-called 'pensions freedoms' came into force in April 2015, most savers were forced to buy an annuity with their pension savings, giving them a guaranteed income for life. Now savers can take their pension fund as cash, and spend it however they choose. But is giving people too much choice a good thing?**

A recent survey by Nottingham University Business School and Willis Towers Watson suggests not. The study of 2,000 UK workers has found that, despite high confidence in the initial stages of the financial decision-making process, 47% of consumers have trouble committing to the final decision\*. And over a third of savers (34%) felt they had too much choice when it came to saving for retirement. None of this bodes well for the thousands of people approaching retirement, who now face the prospect of making some serious financial decisions that will affect them for the rest of their lives.

When it comes to making those decisions, it's not just about taking a pot of money and deciding where and how to invest it (which in itself is a daunting prospect for most). Nowadays, people entering retirement have to think very seriously about their health, and how long they think they might live, as well as be realistic about the lifestyle they want to lead now, and in the future. Making decisions today that will stand them in good stead for anything up to 30 years or more is not easy. So it's no wonder we're finding people in a state of financial paralysis when they reach retirement. While annuities may

not have been the right solution for everyone, and collective inertia meant that most people failed to shop around for the best deal, at least they offered some lifetime guarantees, protecting clients from running out of money.

Earlier this year, the Association of British Insurers published data showing the effect of the pension freedom reforms. In one year, £4.3 billion was paid out in cash lump-sum payments, with an average payment of £14,500\*. The industry reaction was positive, citing the new legislation as a big win for the consumer. But is it? As with all statistics, it's not just about what the data tells us, but what the data doesn't tell us. How much money remained in pension funds, and why? How many people, in receipt of their 'pension wake-up pack' from their provider, panicked and decided to do nothing at all? What has happened to the £4.3 billion paid out in cash lump sums, and how much of it would have been better invested, especially in this low-return environment?

The reality is that we may not know the answers to these questions until it's too late, and sadly it's usually the people who can least afford it that suffer the most. One thing is for sure – no matter what your circumstances, if ever there was a time to seek help with financial planning, retirement is it.

\*<https://www.nottingham.ac.uk/business/news/retirement-plans-under-threat-as-workers-struggle-with-pension-paralysis.aspx>

\*<https://www.abi.org.uk/News/News-releases/2016/08/ABI-publishes-full-year-of-pension-freedom-data>

First published on 14th October 2016 by Sanlam UK.



# HAS QE FAILED, AND IF SO WHY ARE MARKETS CLAMOURING FOR MORE?

**The aim of Quantitative Easing [QE] was to support global economic growth in the wake of the Global Financial Crisis, and help to push GDP growth back towards its trend rate, typically around 3.2 – 3.5% for the world and 2 – 2.5% for the UK.**

This would allow the amount of outstanding debt to be managed and ultimately reduced over time. It was hoped that a virtuous cycle could be started: pinning interest rates down would boost investment, which would improve employment prospects, leading to increased consumption and a self-sustaining recovery where total demand would become strong enough to generate desirable levels of debt-reducing inflation. The problem has been that whilst the cost of capital for companies has been meaningfully lowered, it has not led to the hoped-for uptick in investment, so productivity, wages and consumption have all remained weak. Instead it has merely enabled weaker companies to survive, leading to excess supply at a point in time of sustained weak demand, which has acted as a further depressant on prices and therefore been a disinflationary force.

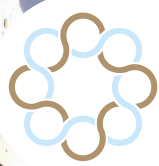
With soft growth and negligible inflation, the global debt mountain consequently remains as challenging today as it has ever been despite QE-driven central bank balance sheet expansion of almost four times since 2007 (the aggregate balance sheet of the US Federal Reserve, Bank of Japan, European Central Bank and Bank of England has grown from

\$3.5 trillion in 2007 to over \$12 trillion today: source Wall Street Journal). As a result markets and policy makers are beginning to question the extended use of QE, though the alternatives appear potentially more disruptive and politically challenging.

The markets' and society's fatigue with QE stems primarily from the rising inequality that it has generated. Whilst "the few" have benefitted from the positive wealth effect of rising asset prices (bonds, equities, property etc.), "the many" have endured flat to falling nominal incomes. Corporations and their shareholders have profited at the expense of employees. Households have faced rising bills and the pain of austerity whilst governments have congratulated themselves on avoiding catastrophe, when in actual fact they have offered little to no leadership, failed to institute any growth-supporting fiscal policies and instead delegated all responsibility for repairing the economy to the central bankers.

Despite the relative calm that QE has brought, its primary goal of rekindling sustainable demand-driven inflation has been a glaring failure. Yes there are glimmers of 'cost push' inflation beginning to emerge, courtesy of a depreciating currency and commodity prices rising from a floor, but typically these pressures are transient and unstable.

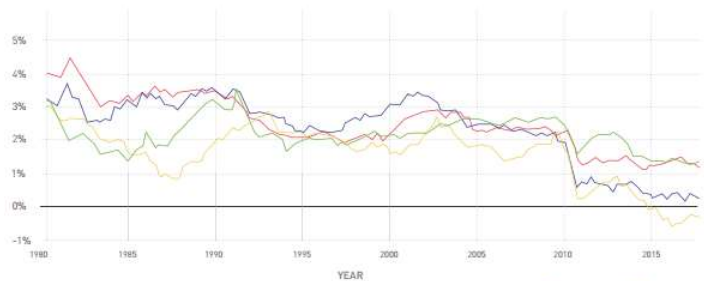
Until confidence is firmly re-established, the benefit of low interest rates is unlikely to manifest itself in increased investment and so the positive money multiplier effect the central bank craves remains elusive. This explains why markets continue to expect the long term natural rate of





interest (the real, ie nominal less inflation, interest rate that supports non-inflationary GDP growth) to remain at historically low levels, see chart below.

Estimated Natural Interest Rate, Adjusted for Inflation



Source: Kathryn Holston, Thomas Laubach of the Federal Reserve Board; John C. Williams, Federal Reserve Bank of San Francisco

The problem is whilst rationally and intuitively many market participants believe a change is necessary, the prospect of moving away from QE raises uncertainty. As a result whenever central bankers have hinted at a reversal of QE, this has led to market weakness, ultimately leading them to withdraw their earlier intentions. This is effectively leading to a dangerous scenario where the counter-cyclical role of a central bank designed to deliver relative economic and financial stability through the cycle is being forfeited. Instead of central banks leading they are increasingly being led, and led by markets addicted to the QE drug, where the prospect of complete withdrawal is always going to be messy and full of unknowns.

So who would want to be a central banker, particularly now? Even after all their best efforts since the Global Financial Crisis (GFC) of 2008/09 to stimulate economic activity and

restore financial stability, global GDP growth remains anaemic, inflation some way beneath target, and business confidence absent. The appropriateness, efficacy and relevance of QE is now being deeply questioned. Yet, at the same time there is a clear hesitancy about its withdrawal. As a result central bankers feel increasingly trapped, damned if they do and damned if they don't. But that is why they have the position of responsibility they have, to take difficult decisions for the ultimate betterment of their respective economies. Let's hope they are up to the task, as ultimately the addiction needs to be broken as QE cannot go on forever.

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