FINURA

PARTNERS

MARKET REPORT Q3 2016

MARKET COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

There are two topics to discuss in this quarterly review, one in the news a great deal and the other perhaps not catching the headlines. The former is the ongoing developments post the Brexit vote and the latter is the good performance from emerging markets this year. Each is covered below.

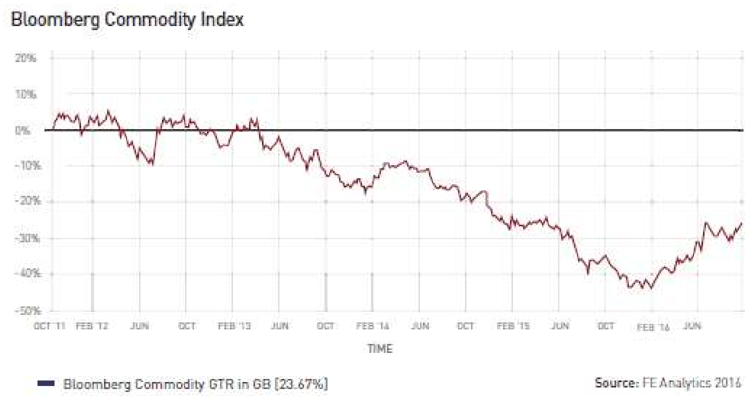
It is now over 3 months since the vote to leave the European Union. Article 50 which starts the two year countdown to leave the EU has not yet been invoked and we are no wiser as to the type of exit the UK wishes to negotiate, whether it be "hard", "soft" or something in-between. Most commentators expect Article 50 to be implemented in 2017, and until that point it is perhaps pointless to speculate on the long term implications of the new relationship between the UK and Europe.

However life goes on and it is worth analysing what has happened to the UK stock market and the economy since June. First, in August the Bank of England lowered interest rates from 0.50% to 0.25%, a new historic low. In addition, it extended its Quantitative Easing programme and introduced a "Term Funding Scheme", providing cheap loans to banks so that they may continue to lend. Some have criticised these actions, citing what kind of signal this sends to individual and companies? Does the Bank of England foresee the economy slowing rapidly and is taking pre-emptive action? How will people behave? Will they cut back on spending and companies rein back investment? The response may well be negative and have the opposite effect from the intended result. Time will tell.

Looking at the evidence the economy appears to be in reasonably good shape. Consumer confidence and demand remains strong. Wages are ahead of prices, unemployment is low and the return on savings is so pitiful that perhaps consumers may rather spend than save. Another consequence of the vote to leave has been the drop in sterling, versus the dollar it has fallen from $1.49 to $1.29. This should enhance the competitiveness of exporting UK companies and may explain the recent strong performance of the FTSE100 index (up 13.8% since the vote) which drives approximately three quarters of its earnings from overseas.

The second notable theme of the third quarter of 2016 has been the resurgence of investor interest in emerging markets. (The FTSE Emerging Market index is up 33% in sterling terms year to date). At the start of the year this was an asset class beset with problems. There were serious concerns about the health and stability of the Chinese economy, Brazil and Venezuela had political problems and commodity prices were depressed.

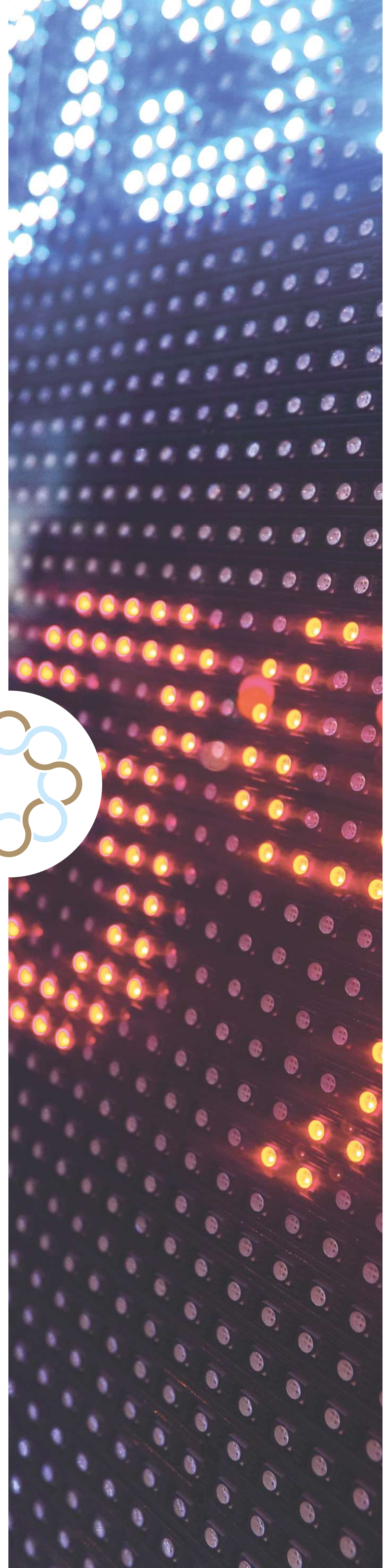
Nine months on and the asset class is in rude health. What has happened? Much of the bounce may be attributable to the rise in commodity prices, the Bloomberg Commodity Index is up nearly 24% in sterling terms (see chart below), as many emerging markets derive significant revenues from exporting commodities, such as Brazil, South Africa, and Russia. Conversely however, countries like India and China do not benefit as they import large amounts of commodities.



Another key driver for the emerging markets asset class has been the direction of interest rates in the United States, which now increasingly appears will rise gently from present levels. Last year it was expected the Fed would raise rates by 4 times during 2016. This has not happened. A rise in rates lifts the value of the US dollar, lowering the price of commodities and hence income and GDP growth in emerging markets. It also makes the dollar denominated debt of EM companies more expensive to repay. Thus with interest rates "lower for longer" in the US and elsewhere in the developed world, emerging markets are less likely to suffer from a rapid rise in the dollar.

As we enter the final quarter of 2016 it is easy to forget that the FTSE World index has risen by 22% in sterling terms, a healthy return for investors. Central banks have maintained low interest rates in order to provide "cheap" money as and when needed to generate economic growth. As always it is important to remember markets can go down as well as up, and to invest according to your risk appetite.

First published on 26th October 2016 by Simon Brett of Parmenion Investment Management.



THE NEXT HORIZON

Business news headlines in the UK over the past three months have been dominated by the various conjured and actual implications of Brexit. And it is not only in the UK that the intensity of coverage has been in line with the degree of shock.

Other EU countries have been trying to digest the news and determine the implications, and there has been media and political reaction in most countries around the world; that the whole of Europe is entering a period of uncertainty hardly needs stating. This is perceived to be greater for the UK than anyone else. However, the political and economic consequences of the UK's decision are potentially equally profound for the EU as an institution and or individual countries within the union.

It is probably not an overstatement to suggest that the UK is facing the biggest challenge for 70 years. How cleverly our politicians and civil servants negotiate their way through the exit process and how successfully they establish new arrangements and agreements, both with the EU and other countries, will have a huge impact on how the economy performs in the longer term and on how other countries react to Brexit. However, there is an even more important response that will define whether, eventually, the UK's exit from the EU will be regarded as essentially damaging or effectively beneficial: it is the response that we see from the UK's businesses.

The initial reaction of many commentators to the referendum result was that the UK was shutting the door on Europe. The more positive interpretation – and the one we expect to dominate strategic thinking in UK industry – is that we are opening the door to the rest of the world. In effect, membership of the EU and, more specifically, participation in the single market have focused attention on exploiting trading opportunities within Europe as the most effective way of increasing exports. While we may not have been shut off from the rest of the world, the single market has always been presented as providing the greater opportunity.

Looking back, boosting growth through greater intra-European trade has always been one of the central doctrines of the EU. However, the more attractive opportunities now lie outside the EU. When the UK joined, back in the early-1970s, the EU accounted for about one-third of the world economy. Now, it constitutes around 15%. It is self-evident from these numbers that the greater trading opportunities lie with faster growing economies outside Europe.

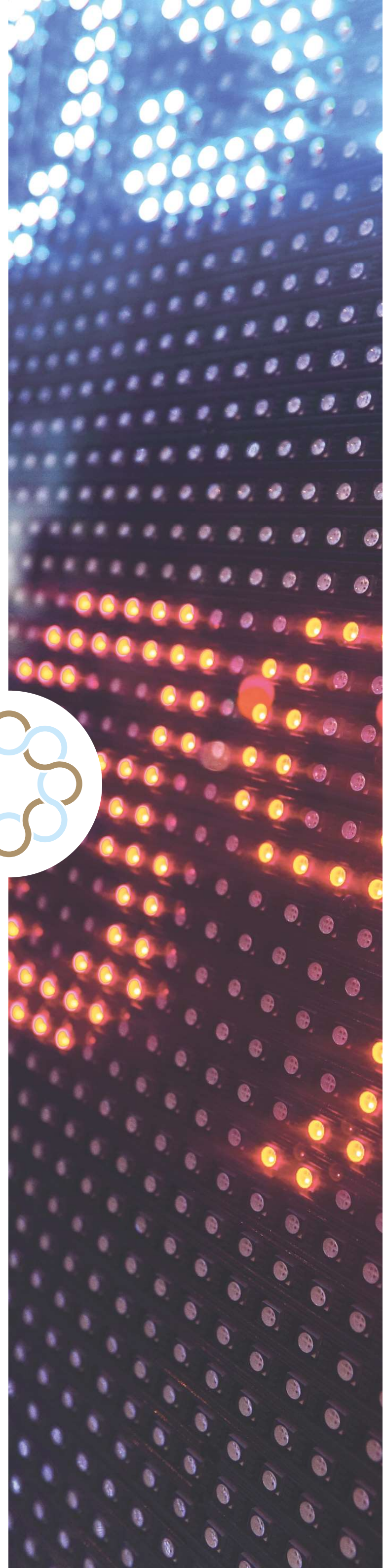
We believe that throughout the corporate sector, strategies will now be developed to identify global export opportunities. So, rather than having a stultifying impact, the Brexit decision could easily turn out to be invigorating. That is not to say it will be a smooth path towards exit. Undoubtedly, there will be some EU member countries that will want to use the UK's exit to their economic or political advantage – or will want, simply, to punish the UK. However, we believe that the current imbalance in trade, which is massively in the EU's favour, makes it less likely that punitive barriers will be raised against the UK.

There is also a risk that two-plus years of uncertainty will cause an economic and investment hiatus that will result in an extended period of lost growth for the UK economy. However, there is another way of regarding this period. Sure, it will take time before there is any clarity with regard to the exact trading and financial relationships that the UK will have with its former EU companions and other potential trading partners. However, the lack of a trade agreement with, say, the US or Australia will not prevent us marketing and selling to these countries. More to the point, the time up to the point at which we actually cut our formal EU ties will be a period in which companies can plan for the future.

While taking a positive longerterm view, it is likely that the UK will see some economic disruption in the interim period. To date, the evidence of the immediate postreferendum reaction is equivocal. Unsurprisingly, the immediate shock of the result was reflected in surveys that showed sharp reductions in consumer and industrial confidence. Since then, confidence indicators have either fully or substantially rebounded.
Hard data is scant, but where available official numbers for indicators such as retail salesand job vacancies have looked reassuring. Certainly, there is no evidence that the UK is sliding towards the feared recession. There will be much more to write on the subject of near-term growth prospects, but we remain of the view that, following their post-referendum huddle, economists became too gloomy about growth prospects for the second-half of 2016 and 2017. We are also of the view that the July easing in monetary policy announced by the Bank of England was at best unnecessary and at worst risked sending negative signals to both consumers and industry.

Being slightly less solipsistic, there have been some subtle, or perhaps not so subtle, changes in growth prospects for countries and areas beyond the UK's shores. Having been steadily gaining momentum in recent years, there is growing evidence that eurozone economies are now decelerating slightly, despite ongoing monetary support from the European Central Bank. On the other side of the Atlantic, the US has re-established a reasonable growth profile, but has failed to match some of the more optimistic growth projections made at the start of the year. While this may continue to provide an excuse to the Federal Reserve (the Fed) not to raise interest rates further, evidence that inflationary pressure is rising is beginning to back policy setters into a corner. What seems clear, however, is that the pace of any tightening will be slow. More to the point, we suspect that central banks generally will prove more inflation tolerant over the coming few years than they have been in the past.

While growth trends in the west have remained dull, emerging economies, both manufacturers and commodity producers, have begun to find life slightly easier. Higher commodity prices and a modestly weaker dollar have helped engender these improved conditions, although the risks have not completely disappeared. In particular, there remain



concerns about the possibility of a credit crisis in China (and the potential for this to spread). Meanwhile, another Asian economy – Japan – continues resolutely to fail to respond to the massive and ongoing monetary easing that has been undertaken by its central bank.

Despite these ongoing uncertainties, equity markets have been remarkably calm. Furthermore, after the immediate post-Brexit volatility, (moving steadfastly higher throughout the quarter); developed markets have made low single-digit returns with higher beta (volatility) markets such as the Nasdaq, emerging markets and Asia having made stronger gains. Yet, however calm equity and credit markets have been through the quarter, government bond markets have seen significant moves, up and down (in price terms), as the spectre of a change in monetary policy direction has started to loom, and not just in the US as the efficacy and limits of quantitative easing start to be increasingly questioned. The 10 year UK gilt yield went as low as 0.5% before rising closer to 0.9%, which might 'only' be a 3% move in price terms, but worryingly it is a number of years of yield. It is likely we will continue to see higher volatility in bond markets as the path of monetary policy becomes clearer across the world.

Outside of core asset classes individual areas such as oil and gold have followed their more idiosyncratic paths. While oil prices have declined over the quarter due to worries over increasing supply from both the US and OPEC (and in particular Libya), the price is significantly off its lows of the year (currently US$ 45 versus low of US$ 26) albeit exhibiting continued significant volatility. Gold has remained steady this quarter after increasing 25% in the first-half of the year.

In the final quarter of 2016 markets have a number of hurdles ahead including whether the Fed will finally raise rates for the second time since the great financial crisis, the US Presidential election and an Italian reform referendum. After a subdued summer, volatility may well increase across more asset classes as investors continue to interpret central bank activities, focus on the real economy and watch actual spending habits of consumers, companies and governments. As such, cautiousness may be warranted with bond markets key to broader market behaviour.

First published on 10th October 2016 by Richard Jeffrey, Chief Economist, and Kieron Launder, Head of Investment Strategy, at Cazenove Capital Management.

FINURA
PARTNERS

Level 2, Juxon House, 100 St Paul's Churchyard, London, EC4M 8BU
T: +44 (0)20 3102 7730 **E:** enquiries@finurapartners.com **W:** finurapartners.com