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Global Market Strategy – September 2016

Janet Yellen and the Fed interrupt the Bull

Henderson Global Investors last week circulated their trustee report on the status of their management of the Group's final salary pension scheme.

The 'Return Seeking Portfolio' returned 1.0% for the 12 month period to December 31st 2015, and the asset allocation which produced this performance was 16% Corporate Bonds, 4.8% Government Bonds, 1.7% EM debt, 13.8% 'Alternatives', Private Equity 3.2%, Property 2.9%, Developed Economy equities 36.2%, EM equities 3.1% and Cash 18.3%. The Scheme is now in deficit, meaning its assets cannot meet its obligations to its members, so Henderson the fund management company, and Henderson the trustees (conflict of interest…?) have agreed a four year program to contribute £8.4 million to prop it up.

Such is the conundrum for pension trustees posed by a continuous bull market in bonds and consequent lower-still yields on government bonds. Final salary schemes depend on a healthy yield on government bonds so they can rely on having a large percentage of their future liabilities to pension holders well-covered. Henderson are a typical example of a fund management group which is caught between wanting to buy bond stability, but at increasing cost and with pitiful yield, and needing to buy equity growth potential but fearful of doing so. Indeed, of the 5945 pension schemes registered with the pension Protection Fund at the end of April this year, 4891 were in deficit, representing a significant worsening in the health of Defined Benefit schemes over the previous year. (It has to be said that many 'DB' schemes are closed to new members; the fewer the number of active members a scheme has, the more its liabilities are fixed and tailored to meeting known or probable retirement dates of the existing members.)

What the Henderson Trustees' report does not state is the charge that Henderson Global Investors makes to the scheme for running it. Should members assume 1% per annum, or might Brewin Dolphin's ongoing annual management fee of 1.3% for 'its financial planning and investment service', as confirmed in the Financial Times, be a more accurate assumption? (NEST, which was set up by the government to make sure that every employer would have access to a high-quality low-cost workplace pension, has an "annual charge of 0.3%, plus a contribution charge of 1.8% for an indefinite period to cover set-up costs".)

Standard Life's Global Absolute Return Strategy fund, referred to as 'GARS', and designed to produce a positive return for clients whatever the type of market we're in, boldly claimed at the end of August that it had grown its funds under management over the first 6 months of 2016 by 6%. Unfortunately for their investors, the fund regressed by 5.3% in the 12 months to the end of July.

After the strong first three-quarters August performance for equities and precious metals, the last week of the month saw markets become preoccupied with whether Federal Reserve Chairwoman Janet Yellen would signal a rise in interest rates, and the consequent results if she did. Not surprisingly, stocks and precious metals retreated as the Yellen speech approached.

In the end she said that 'conditions were increasing the likelihood of a rate rise soon', which was brilliant speak for another postponement. The Fed alluded to the hurt a stronger dollar would have for American exports, emerging markets and at this stage, fledgling growth. At the same time the central bank confirmed that the trend toward inflationary growth was 'encouraging' but not sufficient for a rate hike 'yet'. Janet Yellen also said that an injection of $2 trillion could be made available in the event that a recession re-emerged. This would mean further corporate bond buying and, probably, the purchase of certain blue-chip stocks.

Needless to say markets bounced strongly on news of a status quo and likely future QE, until they began to worry about a late-September rate rise if the US employment figures, to be reported in early September, are strong. On the face of it, emerging markets have much more room for asset growth than, for example, the three principle American indices (the Dow, S&P and Nasdaq) which simultaneously set new all time highs during August for the second time in a week; Metals and Mining and Technology have been the principal beneficiaries of gains made in the last month.

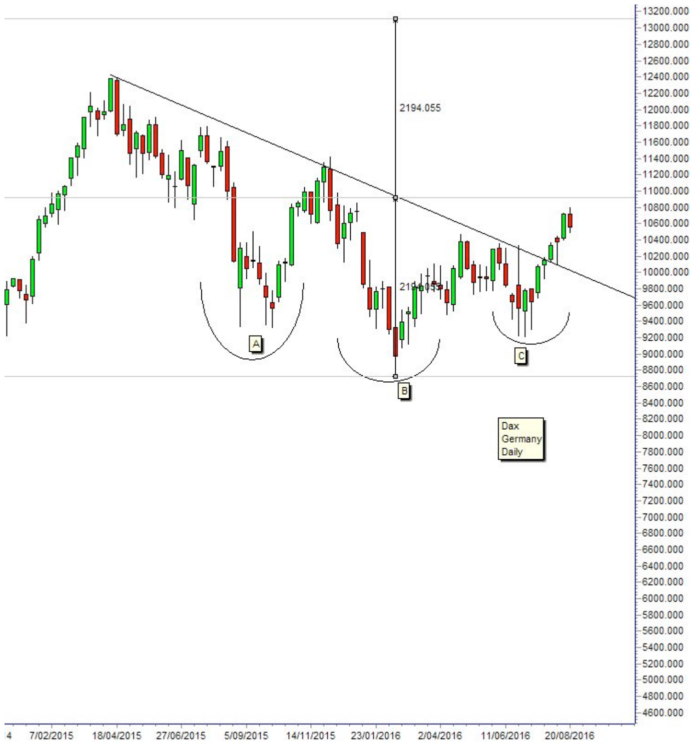
If August is anything to go by, investors might be able to buy stocks and precious metals strongly for the first half of the month and then release the positions before 'Fed-speak worry' resumes toward the end.

September 1st 2016

Those less enthused by further Fed QE are the Japanese. The Yen has steadily strengthened during the year, from Y118 to the dollar in January, to Y100 to the dollar today. If the US seeks to weaken its currency through more bond buying (and probably eventual stock buying), the yen will appreciate. The Nikkei has fallen from over 20,000 in August last year to 16,500 now. On the other hand, if the Fed raises rates, the dollar will rise and provide some relief for Japan. Either way, in theory there should still be considerable scope for Japanese stocks to advance while Shinzo Abe retains his determination to reflate the economy.

The UK property market saw a tremendous spike in activity prior to the 3% additional stamp duty charge in April on buy-to-let purchases. According to Knight Frank, the market softened considerably prior to Brexit; since then, activity has resumed, on the one hand helped by those using foreign currency gains against sterling, and on the other by the simple housing supply and demand imbalance in cities such as Manchester and Birmingham. Economic hubs with good schooling and within reach of London such as Guildford, Sevenoaks and Bishops Stortford have all prospered, while countryside property prices have declined marginally. In London, the market splits into three principal variances: central London where prices year on year are down 2%; west London, notably Knightsbridge and Chelsea where prices are down 6-7%; east London where prices are up 5-6% compared to this time last year.

The German DAX offers an exceptional buying opportunity, according to chartist Daryl Guppy. Guppy normally charts currencies and the Asia markets but he has uncovered a strong ‘Buy’ chart in the DAX.



The chart above shows daily values of the DAX since February last year. The breakout move on the right is a strong trend reversal pattern. The wave patterns are measured and then the breakout move is projected upwards. This gives a long term upside target near 13,100; currently the DAX is at 10600. The target projection doesn't tell how the rally will develop, nor does it give an indication of when the target will be achieved. However, as a strategic analysis tool it is very bullish as these reversal patterns have a high probability of reaching their targets.

Emerging Market equities have continued the favourable momentum seen this year, with Thailand, Indonesia and Philippines offer the greatest opportunity, according to Andrew Ferris of BNP Paribas. Interest rates are higher in Asia than they are in the West, and they have more room for relaxation of monetary policy.

BlackRock upgraded EM equities last month to overweight as the firm expects a stable U.S. dollar, low US interest rates and a better outlook for growth for the sector. Both fundamentals and sentiment have improved for EM. There are signs of stability after a sharp slowdown in China's economy; commodities prices are no longer falling; and the U.S. has not edged closer to recession. Improving EM current account balances, appreciating currencies and attractive stock valuations provide fundamental support.

US dollar stability is a key factor. Strength in the greenback puts pressure on emerging market nations, which may be forced into a competitive devaluation of their currencies to remain competitive, while finding it harder to pay down dollar-denominated debt. Now, "the 'lower-for-longer' US rate outlook reduces the risk of a sharply rising dollar, expands the scope for more EM rate cuts (there have been 25 so far this year), and makes high-yielding EM assets relatively attractive, according to BlackRock analysts.

Investors searching for returns in a low-growth world increasingly favour emerging markets. The iShares MSCI Emerging Markets ETF is up more than 15 percent year to date, versus a gain of 6.8 percent in the S&P500.

In April, Bank of America Merrill Lynch reversed its five-year negative view on emerging markets to become "structurally bullish" on the asset class.

Between 2013-2015, about $150 billion flowed out of EM equity exchange-traded and mutual funds. Investors are now dipping back in, with $26 billion in inflows since February.

Precious metals are in reversal. Since the Fed signalled that conditions had improved the prospects of a rate hike, gold and silver and their associated stocks have fallen anything between 3-18% in a few days. An interest rate increase raises the opportunity cost for holding gold which yields nothing, and the mining companies take a leveraged hit, as do the gold and silver funds which typically have around 70% of their content in the gold and silver mining companies. Precious metals are priced in US dollars, so move inversely to the direction of the underlying currency. There's no doubt the Fed wants to move to a 'more normal' monetary policy (stated as having 2% inflation), so 0.25% rate rise could possibly be tolerated. However, if the rate rise comes now, it probably pushes a further rise to at least mid to late 2017, during which time emerging markets and precious metals prices should move higher.

Many high-profile investors are holding onto their large gold positions. Legendary investor and hedge fund manager George Soros recently dumped the majority of his Barrick Gold (NYSE: ABX) position and booked quite a gain in the process but he's still holding other gold-related investments. Meanwhile, many other investment luminaries like Stanley Druckenmiller are maintaining their large gold holdings. However, these uber-successful investors might be missing the boat on the best play in the precious metals sector: platinum.

Platinum is much rarer than gold. Industrial demand for platinum is much greater than it is for gold, and yet platinum is selling for less than gold. Platinum usually trades at a premium of 25% or more to the price of the yellow metal, not at a 17% discount to gold, as it is today. While this discount is compelling in its own right, that's not the only reason to be interested in platinum.

Platinum is used in catalytic converters. It is up 24% this year, which is close to gold's 26% advance. If history is a reliable guide, platinum will continue to rise if gold resumes its own rise, but platinum could soon begin to rally much more than gold. Global auto sales are booming this year, as they have been for the past three years. In fact, sales in the U.S. and UK will hit their highest levels ever this year. Platinum may not be as shiny as gold, but when precious metals are on the move, it often outperforms its more celebrated peer.

Favoured investment plays:

Nil risk:	USD cash (in preference to Euro cash)
Cautious risk:	AAA Corporate / Government bonds (short duration)
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	UK**,** European equity
Adventurous risk:	**Japan, Asia, Germany,** US equity, UK/European/US smaller company secto
Speculative risk:	Timber, Water, Technology, **China, India, Other EM**, **Gold and gold miners, Silver, Cocoa, Orange Juice, Sugar, Coffee**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 10%, US smaller cos 2%, (Other) US equity 8%, UK smaller cos 10%, (Other) UK equity 4%, Iberia 1%, European Telecoms 1%, (Other) European equity 7%, India 1%, Japan 10%, China 5%, (Other) Asia 14%, Energy 3%, Pharmaceuticals 8%, Long-Short Hedge 5%, Gold miners 11%