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Points of View

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Professional Adviser Awards
Client Engagement Nomination

Professional Adviser awards 2016 FINALIST

On the 11th February, Finura Partners attended the Professional Advisor Awards 2016. From over 200 entrants, we were shortlisted for the Best Client Engagement category alongside 11 other firms.

Although we didn't win on the night, it was a great experience for the team and something we are very proud to have achieved just 2 years after Finura Partners began.

We will continue working hard to become the most highly referred UK financial planning company, delivering exceptional client service from inception to conclusion.

Highlights of the evening can be found at
http://events.professionaladviser.co.uk/awards

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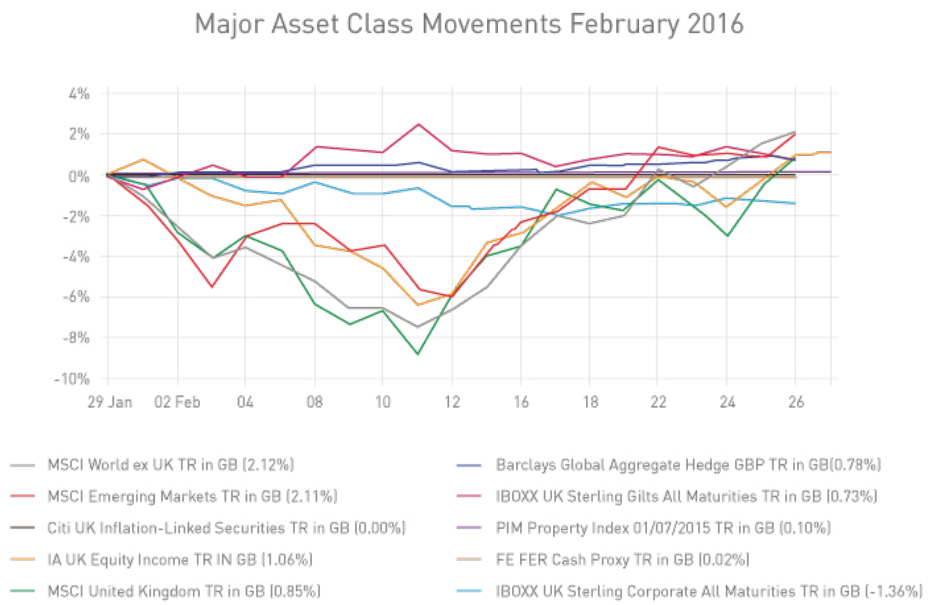
Market Overview from Parmenion Investment Management

Markets continued with the "risk off" theme into February. Equities across most sub-asset groups were down between 6-9% by mid-month, in the context of continuing concerns around a potential recession in the US (manufacturing PMI data was weaker than expected), sagging oil prices and negative earnings outcomes, against a backdrop of elevated earnings multiples.

We then saw a change of direction. Whilst cash, bonds and property had successfully protected capital, most equity markets rallied midway through the month, on the back of expectations that central banks will continue to hold interest rates at sub-zero in Europe and Japan, whilst interest rate increases in the US and UK seem set to be delayed for the foreseeable future.



Data-from-FE-2016
(Source 29/01/2016 – 29/02/2016 Data from FE)

Following this "risk on" rally, only UK investment grade corporate bonds (shown in blue above) finished the month in negative territory, falling 1.36%, owing to increasing concerns that default rates will rise on the back of high levels of M&A in 2015.

On a year to date basis, this means that UK Gilts and UK Index Linked Gilts are the best performing asset group (with returns between 4.5%-5%) owing to their negative correlation characteristics and 'safe asset' status in a "risk off" market. Global Bonds are up approximately 2.3% with UK Corporate Bonds, EM and United Kingdom equities only slightly lagging with negative returns of -0.7%, -0.8% and -1.5% respectively, and all other asset groups being relatively flat over the period.

UK

The UK stock market has been one of the worst performing asset classes since the market peaked around June last year, with a negative return over the period of -10.49%. The UK market has suffered from a barrage of headwinds including volatile oil prices, concerns over dividend cover in the largest companies, uncertainty arising from a possible Brexit and concern over the impact of a relative rise in Sterling on exporters as the ECB continues to devalue the Euro, given Europe is such a significant trading partner.

The UK is particularly exposed to movements in the oil prices, as large oil, gas and commodity producing companies have a higher than average weighting in the UK market. Over the course of February, UK Equity fund managers achieved returns around 1%. Even as sentiment towards Oil and particularly Miners improved, Banks started to act as a drag. Nevertheless, smaller companies underperformed the FTSE-100 as rhetoric around the UK referendum on Europe grew louder. Sterling falling increases the value of offshore earnings relative to domestically focused stocks, making companies that earn overseas look relatively appealing.

Looking forwards, many investors now seem to be increasingly optimistic. Valuations have become more attractive and Brexit negotiations may provide an opportune time to buy high quality companies with sustainable cash flows.

US

On the back of increasingly weak manufacturing Purchasing Managers Index data, the US market increasingly discounted the probability of the Federal Reserve's planned 4 interest rate rises for 2016. A growing consensus holds that economic growth is likely to be weaker than anticipated. This has led to movements in the yield curve leaving lower risk investors increasingly vulnerable, should the Fed move to increase interest rates as previously guided.

So, in a display of confidence, the Fed opted to reassure markets by reminding investors that consumer spending makes up close to 70% of the US economy and is doing well, whereas the struggling manufacturing sector is only responsible for 10% of GDP.

With unemployment close to record lows and with increasing real wages, the consumer appears to be in a relatively strong position. This means the risk of the US entering a recession is lower than some expected and an increase in interest rates should still be considered as a distinct possibility.

Internationally, in a classic "flight to safety", many investors have moved to the US Dollar over recent months which continues to create demand for US investment assets despite valuations that are high, relative to their historic trading range. The risk-off rally, led to a significant bounce in US equity market returns, with the MSCI North America index up close to 9% from mid-February to the end of the month.

Europe

A large proportion of the rise in value of European equities in recent years has come from an increasing earnings multiple, on the back of a strongly supportive central bank and continued loose monetary policy. These historically high multiples have come under significant pressure since June 2015 and despite a rally of circa 7.5% since mid-February, the market p/e ratio remains below its long term average.

Investors are increasingly optimistic that a fragile European recovery, low inflation and a more volatile macro backdrop, may dictate a further loosening in monetary policy which could potentially be positive for riskier assets.

Japan

Japan's economic recovery remains elusive, as seen by a contraction in GDP of 0.4% in the last quarter of 2015. In reaction to this, the Bank of Japan reduced interest rates into negative territory at the end of January. Ironically all this has done is accelerate the flight to safety, which has placed upward pressure on the Yen, squeezing Japan's many large multi-national corporations ability to export.

Until these large corporates are sufficiently confident of their long term profitability to raise wages Japan is likely to struggle to recover. Often it is in the hour of greatest need that tough political reforms are enacted which can help to spur an economy back to life. The Abe government has been contemplating a number of these for some time. Perhaps we are nearing the time for action.

Emerging markets

Although the US Dollar has weakened somewhat in 2016, the capital outflows from

Emerging Markets remains as strong as those seen in 2015 when over $730bn was withdrawn. This reflects not only the partial unwinding of 'tourist' money that entered the EM asset class with Quantitative Easing but also structural challenges facing a number of the larger, emerging economies.

Concerns over Chinese banking sector stability have been extensively aired, Brazil's dire corporate governance is well known and Russian oil price sensitivity has even started to filter into a more positive dialogue with OPEC. As a result, whilst valuations are never, by themselves, a signal to invest, at some point the lack of an appetite for this asset class will change, and for long term investors current valuations look increasingly attractive.

First published on 3rd March by Stephen Lennon of Parmenion Investment Management.

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Are the doomsayers correct?
Reasons for long term investors to be sanguine

So far, 2016 has been a challenging time for investors and it is therefore important to ask whether the recent bearish headlines and commentary are correct or whether there are reasons for long term investors to be sanguine?

The old saying goes, "where there's muck there's brass". In investing terms this could be translated to "where there's volatility there's opportunity". Whilst the market movements over the past six months have been painful in the short term, a number of opportunities have presented themselves.

Before going into detail, I would point out that equity market valuations were not particularly stretched before the sell-off. Yes, the developed markets were beginning to look slightly expensive but many would argue nowhere near "bubble" territory. Therefore, many of these equity markets are beginning to offer reasonable value again on a number of different measures.

Calls for an imminent recession in the U.S. feel wide of the mark. When one looks at the U.S. economy which created 262,000 jobs in December and 151,000 jobs in January, has falling unemployment, a confident consumer and reasonable GDP growth of 0.70% in Q4 2015, an imminent recession feels unlikely, although possible. Therefore, risk assets look interesting at current valuations.

Equity markets have, unusually, been highly positively correlated with the oil price. This is somewhat illogical as a falling oil price means more money in the pockets of western consumers which feeds through to greater confidence and, ultimately higher inflation in the long term.

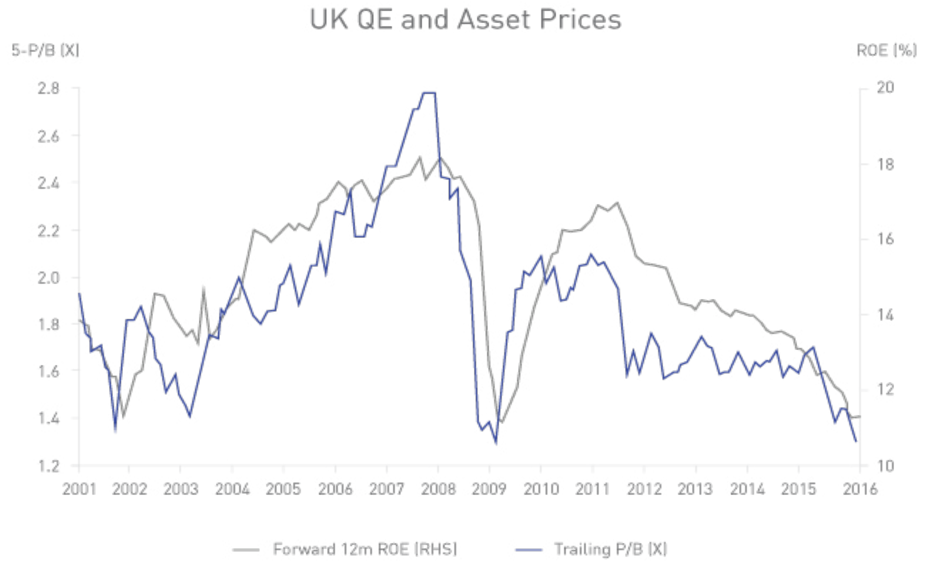
All good things in the process of central bank normalisation in the U.S., U.K. and Europe. There is however, a risk that the fall in the oil price results in an ingrained expectation for lower inflation, or outright deflation, but this is a tail risk rather than a central scenario.

A major impact of the oil price is in the expected default rates in the high yield bond markets, particularly in the U.S. where Energy makes up 17% of the high yield index. Figure 1 shows that the additional yield over U.S. Treasuries demanded by investors to compensate for default and interest rate risk has now risen back to levels last seen in 2011 at the height of the European debt crisis:

Figure 1

One could argue that this dramatic spread widening is symptomatic of a sentiment driven market, where the entire index is being treated as if it were an Energy company in real danger of default. Therefore, for the nimble investor, this environment is offering pragmatic yet careful long term investors with an interesting source of meaningful opportunity.

Looking further afield, Emerging and Asia Pacific ex Japan equity markets are now priced at extreme levels. Figure 2 shows that the Price to Book (P/B) ratio of the MSCI Asia Pacific ex Japan index is now as low as it was at the height of the Global Financial Crisis:



Source: Goldman Sachs

With the index priced at a mere 1.3x book value, is such pessimism warranted? Such extreme valuations could offer opportunities to buy good quality companies at very attractive valuations for the pro-active investor.

Another source of strain has been the strength of the U.S. Dollar. Being long the Dollar has been a consensus position for a number of years now and whilst the Dollar is strong, there are signs that its appreciation may be slowing. A weaker Dollar could create a positive feedback loop into high yield bonds, Europe, the Emerging Markets and other asset classes through a reduced financial burden from Dollar denominated debt.

In summary, whilst the recent volatility has been uncomfortable, it has also revealed some compelling opportunities. For long term investors, the temptation to succumb to panic should be resisted. To paraphrase Warren Buffet "be greedy only when others are fearful".

First published on 15th Febraury by Stephen Lennon of Parmenion Investment Management.

Should we believe everything we read in the media?

Financial markets and economic variables do not move in straight lines; they are all beset by degrees of randomness. The problem arises when volatility becomes greater than normal.

The brain learns quickly to disregard low-level noise; more extreme noise is harder to ignore and can be very distressing. While I do not believe that recent volatility in financial markets is simply noise, it is questionable whether it warrants some of the more hyperbolic newspaper headlines we have read.

It is always important to look at unexpected moves in financial markets and ask a basic question: should they cause us to alter our view of the world or are they a reflection of unwarranted anxiety? On the one hand, it is all too easy for conviction to become a stubborn refusal to accept being wrong. On the other, Keynes's famous comment, "when the facts change, I change my mind", presupposes a degree of certainty about what constitutes a fact. So, there are fine lines between conviction and obstinacy (or complacency) and between open-mindedness and vacillation.

The post-recession environment has been characterised by much duller growth rates in the more mature industrial economies. But duller in this context means safer. In economics terms, countries are still rebalancing and a prerequisite for this process is that growth is at a sustainable rate – a rate that does not require the support of rising debt levels and that is not characterised by widening trade imbalances. By definition duller is also less exciting; moreover, it seems to have less of an in-built safety margin. When the UK was growing at rates of 3% and more, a loss of momentum did not seem particularly threatening. Growth at 2% leaves us with a distinct impression of vulnerability. Given this, it is unsurprising that when faced by something new and with possibly negative consequences, markets react nervously.

If slower growth in the West is one key post-recession characteristic, another is over-supply amongst emerging manufacturers and commodity producers. Prior to the recession, excess demand in the West was very attractive if you happened to have an economy located somewhere along the supply chain. In effect, overheating in the industrialised world prompted other countries to start industrialising faster, and also encouraged resource producers to invest heavily in new capacity (a process that continued post-recession).

For emerging manufacturers, the environment now is far less comfortable. They are experiencing much slower growth in demand for their exports, heightened competition and downward pricing pressure. Similarly, raw material and energy producers are also being forced to confront duller demand trends, greater competition amongst suppliers and downward pressure on prices. This situation has been exacerbated by some producers trying to maximise revenues by raising output. The consequences can be seen most obviously in the oil market, which has been further destabilised by the emergence of the US as a meaningful producer (albeit, further development there will not take place at current price levels).

This raises a key question: to what extent will developments in emerging economies have a detrimental impact on the West? While some Western countries are oil producers, the much stronger influence on Western growth from weakness in energy and commodity markets (and also from depressed manufactured goods prices) is through the demand channel. In effect, lower import prices provide a stimulus to real domestic spending – most obviously through stronger growth in household demand. Other sectors of the economy will also have benefited from declining fuel and raw material prices. For instance, heavier corporate users will have seen a reduction in input costs, potentially benefiting profit margins.

Were prevailing developments in China and other emerging economies to have an appreciably detrimental impact on the West, it might be expected to come via one of two routes. Of lesser worry would be a negative wealth effect on spending as a result of declining financial asset prices. Having said that, if weakness in financial asset markets were to lead to falling property prices, then the impact could be greater. The second route through which Western economies could be hit is via a possible constriction in credit availability. Were Western banks to find themselves undermined by heavy and rising bad debts arising in emerging markets, this could limit their ability to lend to customers in their home markets.

In this context, some UK banks do have significant exposure to emerging manufacturers in Asia (including China). However, there is currently no suggestion that problems in those countries are changing lending behaviour here. Indeed, recent credit trends indicate that the monetary environment in the UK and other Western economies is continuing to improve.

Overall, we would expect to see slightly stronger growth in industrialised economies in 2016 than was recorded in 2015. The UK has already decelerated to an annual growth rate that is in line with that sustainable in the longer term (about 2¼%), and we expect to see momentum maintained at this pace in 2016. Likewise, we expect growth in the US economy to continue at around 2½%. On the other hand, we expect both the eurozone and Japan to accelerate modestly in 2016, from sub-standard growth rates in both areas in 2015.

This analysis does not suggest that we have nothing to worry about. However, the heightened volatility that has been experienced in equity markets over the past few months seems to us to exaggerate the risks that are currently facing Western economies. So, rather than believing that markets are warning us that something nasty is lurking just ahead of us, I would put greater weight on the observation made by Paul Samuelson, the American Nobel-Prize-winning economist: "Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties."

First published on 22nd Febraury by Richard Jeffrey, Chief Investment Officer at Cazenove Capital Management.

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