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POINTS OF VIEW

MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

Markets have been quiet over the past month. The Vix Index, which tracks US equity market volatility, fell to just 8.3, with similar levels of calm seen in other indices. This translated into minimal movement in most equity markets.

The dollar index has continued its decline since Trump's election. A weaker dollar was a key election promise, albeit delivery seems to be the product of his failure on the remaining agenda. Despite the market re-evaluation of Trump's reflation plan, the end of June saw policymakers in Europe and the UK attempt to pick up the baton with hints of a more hawkish stance, albeit subtle and understated ones. Bond and currency markets lapped this up and in the face of limited new news talk of increasing rates has taken centre stage.

How far this story runs will be interesting – is it another false dawn on the road to global interest rate normalisation, or has inflation finally taken off?

Index

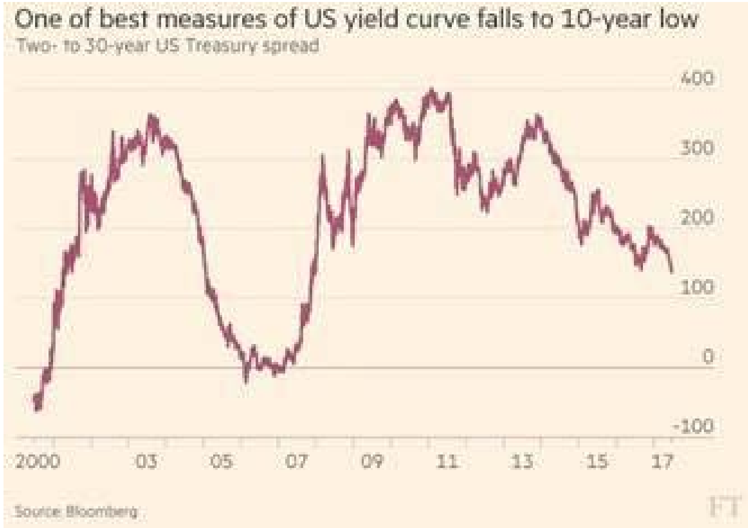
Index	June Return (£ base)
FTSE World Index	-0.15%
FTSE USA TR GBP	0.02%
FTSE Europe ex UK TR GBP	-1.35%
FTSE Japan TR GBP	0.48%
FTSE 100	-2.44%
FTSE all share	-2.47%
FTSE EM	-0.06%

*Source FE June 17. Past performance is not an indication of future returns. The value of investments and any income from them is not guaranteed and can go down as well as up.

United States

June saw the Fed raise rates by a further 25bp. They also set out plans for trimming the $4.5tn asset reserves created by QE. Inflation figures in the US continue to come in below expectation, with the core rate falling to 1.7% last month. Despite very strong employment figures, wage growth has continued to stall. Further concern surrounds a fall in retail sales coinciding with slower growth in consumer credit.

One signal under ongoing attention is the continued fall in the steepness of the yield curve. The spread between the 2 year and 30 year US Treasury bonds is at its lowest point since 2007. Historically an inverted yield curve (when short-term rates are higher than long-term) has been a strong predictor of impending recession.



Source Bloomberg.com June 17

Auto loans are a further topic of excitement for the bears. US auto credit has shown a marked deterioration over recent quarters, with newly "delinquent" (overdue) loans at a post-recession high of $23bn for Q416, while "seriously delinquent" loans touched $8bn. The deterioration as expected sits mostly with subprime loans, which make up 25% of total auto lending. While being a mere 2% of the $12.6tn US consumer credit market, in a period of record low-interest rates and unemployment, this is a signal of distress to be watched carefully.

United Kingdom

By the time the polling booths closed, it was clear that Theresa May had made a mistake calling an election and

that Corbyn had embarrassed her on the campaign trail. As it turned out, not only did she fail to achieve a strong mandate to negotiate a hard Brexit, she also managed to lose her majority. A hastily funded deal with the DUP allows her to continue in government, but her 'strength and stability' has deserted her. Labour's revival came from a surge in voting by the young and coincides with a countrywide split in opinion on the benefits of Europe and the type of Brexit preferred.

While confusion and political weakness tends to imply currency underperformance, the pressure on our Brexit negotiators from a precariously weak majority has seen markets cross their fingers for a softer approach. Equally, European politicians appear in confident mood.

In the bonds space, as the month drew to a close, Carney opened the door to a rate rise. The pound jumped higher while the 2 year rate moved above 25bp for the first time in 9 months. Carney's warning that continued economic growth would eventually lead to higher interest rates is markedly different to his tone just a week earlier where he stated 'now is not yet the time' to raise interest rates. While one of the 3 'hawks' who voted for a rise the last meeting is leaving the monetary policy committee this month, he will be replaced by the Bank Economist Andy Haldane who has voiced his support for a rate rise this year.

UK economic data was mixed in June with good construction figures but weak services PMI, while Consumer Price Inflation rising to 2.9% continues to hurt as those on average pay have yet to experience wage growth since 2008.

Europe

Initial market reaction to Draghi's speech at the end of June, suggesting that "deflationary forces have been replaced by reflationary ones", lifted the Euro strongly. Qualifying comments from ECB members a day later attempted to moderate this positivity, tempering the expectation that the ECB may look to taper QE. Even so, Europe appears to be taking over from the US as the region to look to for encouragement on growth.

Consistently improving data from the core and peripheral economies has helped generate strong equity returns, and a Cape ratio of 15.6x implies Europe remains relatively cheap. Corporate earnings growth has struggled in recent years with low inflation and worries over the periphery.

The recent earnings seasons have been more positive and this month we saw confidence returning in peripheral banks, a further sign that investors are putting faith in the recovery.

Japan

Toshiba held its annual meeting yesterday, just days after the Tokyo Stock Exchange confirmed its demotion to the second tier of the Tokyo Stock Exchange. The company is staring at an estimated loss of $8.9bn with negative shareholder equity of circa $5bn making its demotion automatic, despite potentially occupying 10% of its new index. Aside from the embarrassment, the impact of falling out of a leading benchmark could see 10% wiped off the share price as passive funds adjust their holdings. While the problems stem directly from the purchase of a now bankrupt Westinghouse nuclear unit in the US, the failings run deeper and highlight the lack of corporate governance systemic across Japanese businesses.

In 2015 it was revealed that Toshiba had been investing profits to the tune of $1.3bn over the previous seven years, and while this figure seems paltry next to the $6.3bn write-down from Westinghouse, the underlying governance issues continue to persist with PWC Aarata failing again to sign off their accounts for the year to March. Toshiba is fighting hard to sell its chip business with the aim to plug the hole in its finances, that will not only avoid delisting completely but more importantly avoid bankruptcy. Given the backdrop of Abe's push for cultural change at a corporate level, Toshiba stands as perfect motivation to continue this difficult path to enlightenment.

Emerging Markets

This month Argentina issued a 100 year bond for $2.75bn, maturing in 2117. While this created quite a stir, the practical difference to a more conventional 30yr bond is limited. The duration is less than a year greater at 12.7 years, and given the implied risk of default for an equivalent 30year bond comes in at circa 90%, the incremental risk for the last 60 years is almost negligible.

Also occurring last month was MSCI's announcement of its decision to include China A-shares in its benchmark emerging market indices with a 5% inclusion factor spread over 222 qualified stocks. While a small step, it is the path to what will surely represent a larger influence for global investors. Initially, at least it will bring $10-15bn of inflows from passive and active funds benchmarked to the MSCI.

Implied volatility in June has fallen to its lowest level on record, down 78% since it peaked in 2011 at over 60%. The most recent contraction is largely due to positive price action, however, it still exists in the face of many political tensions across both the developed and developing world.

Despite the sell-off in commodities last month, specifically crude oil, emerging markets held flat, holding on to the strong performance this year. While in 2010 commodities were a large factor in the EM index, today they account for just over 10% while Technology makes up over 25%. This implies that an investment in EM has become far less a play on the commodities demand of a rapidly growing China than a decade ago and far more a play on manufacturing and consumer demand currently making Asia the world's fastest growing region.

*All performance data quoted in this article is derived from FE Analytics. Any figures quoted are for illustrative purposes and should not be taken as a forecast or guarantee. Past performance should not be seen as an indication of future returns and clients may get back less than they have invested.

First published on 4th July 2017 by Parmenion Investment Management.

IF RISKY ASSETS HAD A RIGHT TO HIGHER RETURNS, THEN THEY WOULDN'T BE RISKY

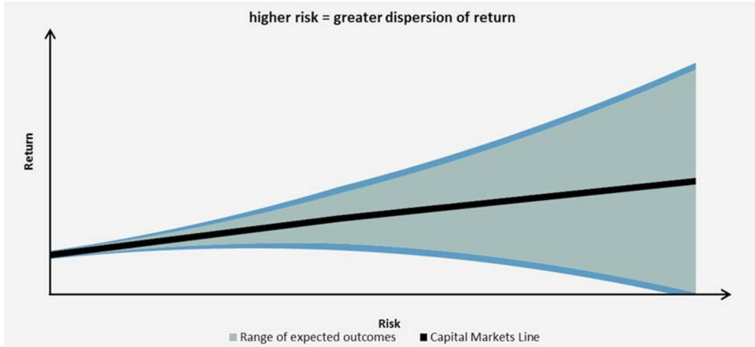
As equity markets continue to reward investors, it becomes increasingly challenging to remain disciplined. But there's little that makes me more nervous than elevated asset prices which are unsupported by underlying data – in some cases exactly the conditions we're experiencing today.

Since Donald Trump was elected, we've seen rising valuations across asset classes, and growing optimism as investors get comfortable forecasting growth further and further into the future. It's this optimism that has seen risk premiums (the incremental amount of reward you should get for taking extra risk) steadily evaporate, as investors are prepared to pay for these optimistic forecasts. So far, investors have been rewarded for waltzing further along the risk curve in search of yield, but assuming this will continue could be dangerous.

Taking more risk for less reward

In the good times, such as now, when risky assets are producing stellar returns, it is easy to get sucked into the belief that taking risk will lead to a higher return. However, if you look at the graph below you will see that taking more risk means a greater dispersion in expected outcome, i.e. less certainty.

On the left we start with a risk-free investment, such as a short-dated, government-backed note. As you progress further out along the black "Capital Markets Line," investments become more risky, which should, on average, produce an incrementally higher return, but also incrementally less certainty.



It's up to investors to demand sufficient compensation for shouldering this uncertainty. When a margin of safety is not on offer, history has consistently shown that it's better to watch from the side-lines, and wait for the risk/ reward balance to recalibrate. Recent conditions have demanded a great deal of patience waiting for this to happen, resulting in investors carrying on regardless.

What we are seeing in the market is that investors are giving up on their lower-yielding, safer investments and taking more and more risk at exactly the time when we think one should be considering the opposite. That's not to say that a long-term investment strategy should be abandoned and we all flee to gold, just that it's worth bearing in mind that preserving capital is a vital focus, and we think now is a good opportunity to look objectively at one's portfolio.

When increased risk becomes the new norm

Due to the prolonged period of very low interest rates, other asset classes look relatively attractive by comparison and money has naturally flowed there, pushing up prices. For example, only a few months ago, corporate bonds were trading at an attractive discount to government bonds, so it made sense to buy them. But now, these same bonds are trading at a yield that is much closer to government bonds and we have to question whether we are still happy to hold them. To get the same return as before, an investor would now have to buy something more risky, say a higher-yielding junk bond.

For several years this approach has borne fruit, perhaps resulting in investors becoming a little too comfortable, to the point where it doesn't actually feel all that risky anymore. That could explain why the market barely blinked at the recent Fed rate hike and guidance that their balance sheet may start to shrink soon. Only a year ago, markets were fixated on when central banks would start to increase interest rates, and such an announcement would almost certainly have precipitated a sharp sell-off.

There's always a window of opportunity

Of course, my position of nervousness and caution doesn't mean we don't see any opportunity. There are always pockets of value to be found. For example, we have recently benefitted from the high growth rates in Asia where expectations were quite reasonable.

It's up to investors to insist on proper compensation for taking on uncertainty, i.e. the valuation of investments must not require the realisation of overly optimistic assumptions in order to achieve a satisfactory return. When this compensation is not on offer we must be careful not to fool ourselves into thinking that things are more certain than they really are.

First published on 19th June 2017 by Matthew Brittain, Investment Analyst at Sanlam UK.

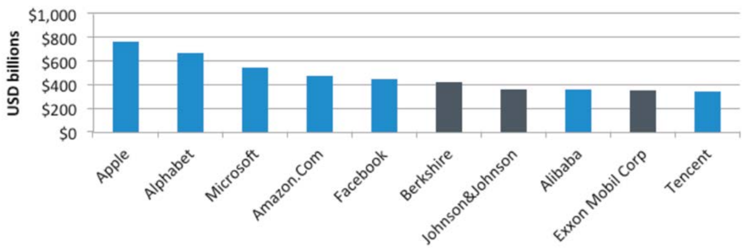
TECHNOLOGY: IS IT TIME TO LAY THE GHOST OF THE DOT-COM BUBBLE TO REST?

When technology stocks suffered a sudden and dramatic sell-off in early June, it was hard not to be reminded of the dot-com bubble. Believe it or not, that was 17 years ago - but the impact lives on in the memories of investors.

The technology sector has come a long way since then. For starters - it's profitable. But it's also a more mature and stable version of its former self, finally delivering on the promise of 20 years ago. With technology stocks playing an important part in client portfolios, we take a closer look at how the sector has developed and its prospects for the future.

A technology business is classed as one that 'revolves around the manufacturing of electronics, creation of software, computers or products and services relating to information technology'. In today's world, that defines six of the world's 10 most successful businesses (seven if you include Amazon, which is not strictly defined as a technology stock).

Largest 10 companies in the world by market cap



Source: Bloomberg

With some technology share prices appreciating by as much as 60% so far this year (massively outperforming the broader market, which is up by 'only' 11%), the sector is enjoying a period of robust growth. But is this sustainable, or are we already in bubble territory? We believe it is sustainable, and here's why:

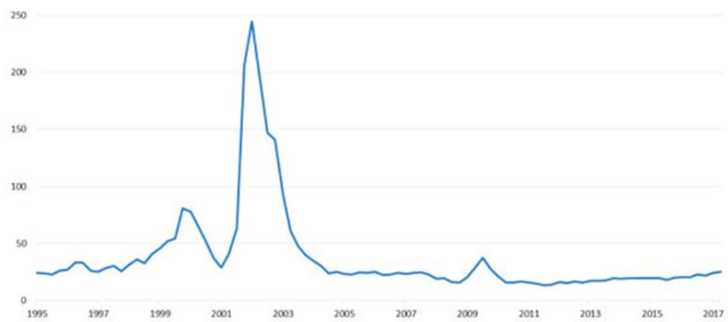
- In the midst of the dot-com bubble (roughly 1997-2001), investors saw the potential of technology business and their ability to change the world. While they were right about the future impact of tech on our everyday lives, they were wrong about the sector being a good investment at that time. Valuations made little sense and many companies were making no money. Put simply, the market got ahead of itself.

- The businesses that survived are now delivering on the potential that drove the frenzy. The big technology firms are very well positioned for the future. Their products are so good that users don't want to, or almost can't, leave (Facebook is a prime example). This makes it very difficult for competitors to break into the market.

- Larger firms in this sector have become more diversified, and are able to buy up innovative new companies before they become potential rivals.

- The graph below shows the price-to-earnings ratio of a basket of technology stocks. This ratio shows the multiple of earnings investors are paying for a share. The higher it is, the more 'expensive' it is. You can see that the shares have become gradually more expensive over the past few years, but they are nowhere near the levels they were back in 2000. In fact, in many cases, they are no more expensive than the general market, which makes them more attractive given they are growing their earnings much faster.

MSCI World Information Technology Index - PE Ratio



Source: Bloomberg

Of course, when it comes to investing, there's no such thing as a sure bet and there are very definite risks involved in technology. Companies in this sector could be susceptible to changes in government regulation, especially where data privacy and protection of young people is concerned. Also, historically, very few companies have been able to maintain the profit margins that tech stocks are currently enjoying for the longer-term. Possibly, at some point, they will lose their edge and not turn as much of their sales into profits.

That said, given the growth in size of the global internet user base, the rise in mobile technology, and the pace of innovation, it will be very difficult to ignore this sector for some time to come.

"The technology sector is an exciting area of the market, with robust growth expected for the foreseeable future. Barriers to entry are far higher than they were 10 years ago, with the biggest and best companies becoming increasingly powerful. In our view, longer-term investment in stocks such as Google (now Alphabet), Tencent and Microsoft gives investors the tailwind they need in today's market, although we are avoiding some where the valuations are expensive." - Niel Laubscher, Global Equity Analyst

First published on 4th July 2017 by Sanlam UK.

IS THE US EQUITY MARKET A VICTIM OF ITS OWN SUCCESS?

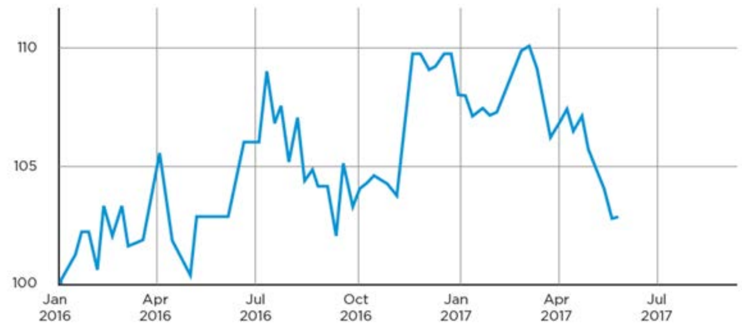
US equities have been enjoying a prolonged purple patch, with trillions of dollars flooding into the S&P 500 (an index that is widely regarded as the best gauge of US company performance) over recent years. The US has outperformed most other equity markets since 2009, by properly addressing the issues created by the 2008 financial crisis allowing it to benefit from superior business performance, while the rest of the world failed to get its collective act together.

But times are changing. Prior to the financial crisis, US businesses made up around 50% of the MSCI World - an index that tracks the performance of the world's leading businesses. At the start of this year, that figure stood at a remarkable 64%. Today, however, it has fallen back to 57%. This is not necessarily due to fears for the US economy, but more that US equities have become too expensive relative to other markets. Now that other global economies are starting to recover, the investment momentum has shifted in their favour.

Over the last few years, the US offered a welcome source of reasonable growth and stability, attracting the lion's share of investment flows and, consequently, inflating prices. As the economies in other regions (such as Europe, emerging markets and Japan), continue to come back to life, active fund managers are able to act upon new opportunities with increased confidence, and are allocating to these regions at the expense of the US.

Of course, we're not writing off the US just yet. Trump's agenda of tax cuts and de-regulation should support economic growth and therefore company earnings. Also, even if Trump fails to achieve any of his agenda points, we know that regulation and taxes aren't going to get any worse. But much of this optimism is already reflected in share prices. Against this stable but expensive backdrop, investors are more comfortable with the global economic outlook.

US equity relative to global peers



Source: Bloomberg

"With valuations high, an underweight position in US equities is becoming the consensus view. We have been well positioned for this rotation out of the US, as reflected by the strong performance our clients have enjoyed. We think there is still some room for this trend to continue."
Philip Smeaton, UK Chief Investment Officer

Why the rise in passive investing favours active investors
Passive investing has surged in popularity recently, attracting in the region of £2 billion of in-flows every day. This flow of capital means that anyone tracking the S&P 500, for example, would have experienced excellent returns over the last few years.

For active investors, this herd mentality brings opportunity. As valuations become stretched with large in-flows, there is a danger that the index will fall, creating a similarly self-reinforcing outflow. In the meantime, active managers can look elsewhere for hidden prospects at a more granular level, finding opportunities that are almost always missed by merely tracking an index.

Because passive strategies give little credence to the underlying strength of a particular business, so its intrinsic value can be under-appreciated. As active managers, we hope to deliver a return that truly represents our highest conviction ideas; taking this risk is the only way to deliver great performance.

Infrastructure funds – an alternative to bonds?
It's safe to say that fixed income assets have been a difficult nut to crack in recent years, and the challenges look set to continue. Government bonds are expensive relative to their own history and they remain vulnerable to higher inflation and growth surprises. And while corporate bonds were offering some solace, the global hunt for yield has driven even these prices to expensive levels, making them less attractive.

As an alternative to bonds, infrastructure funds can offer predictable and reasonable returns over the medium term. They invest in companies that own and operate essential public assets such as roads, airports, rail, power lines and communication towers. These underlying assets are attractive because they offer:

- High barriers to entry
- Constant demand for services
- Government backing
- Predictable cash flows
- Protection against rising inflation

We're always looking for ways to meet the investment needs of our clients. In the absence of good returns on traditional fixed income assets, we would certainly look further afield to achieve some stable returns.

"Passive investing shifts the decision from choosing an individual stock to a decision about which asset class to be invested in. Like anything, the success of one over the other will be cyclical, and both will have their day in the sun. Right now, passive investing is in vogue. But as investors search for the best performing asset classes, driving up prices, active managers may have an opportunity to seek outperformance in other places."
Matthew Brittain, Investment Analyst

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