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MARKET REPORT Q2 2017

MARKET COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

"History does not repeat itself but it rhymes" is a quote attributed to Mark Twain. In the case of Conservative Prime Ministers it seems this is certainly true!

This time it is Theresa May who has been weakened by The UKs relationship with Europe, taking her place amongst others who have been felled by the UKs relationship with Europe; Thatcher, Major and Cameron.

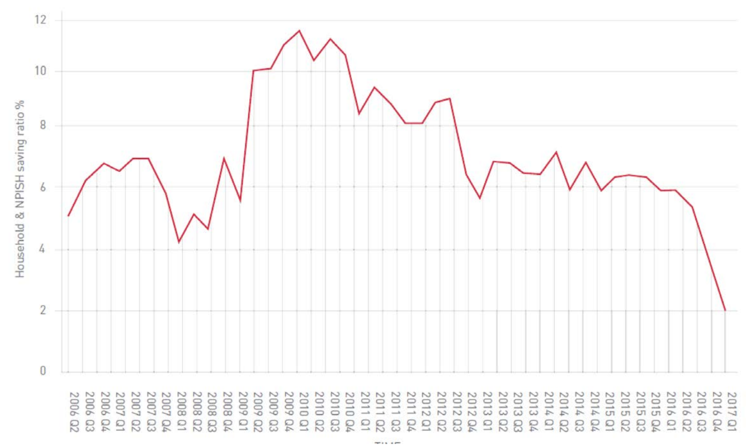
The surprise election result actually reduced a Conservative parliamentary majority to that of minority government, casting a pall over the type of Brexit that eventually may be achieved. Whether it be "hard" or "soft", or something in between, Brexit is unlikely to be resolved until the status of EU citizens living in the UK is fixed, the status of the border between the north and the south of Ireland determined, and the exit bill the UK has to pay to the EU is calculated.

Post the referendum in June of last year, the weakness of the pound has led to a rise in inflation, which is now at 2.9%. However, with wage increases stagnating at just 1%, real living standards are once again falling. It appears that, in order to maintain current levels of spending, the consumer is borrowing and running down savings. Savings are at a multi-year low. For every £100 earned the UK consumer is saving a paltry £1.70! Credit card debt is also rising.

Given that the consumer has been a mainstay of the UK economy during the past year, the question arises whether current levels of spending are sustainable, and what happens if the consumer begins to rein back spending? Watch consumer and business confidence for early signs that the economy is slowing.

The above leads to the interesting question as to when the Bank of England will raise interest rates. At the last meeting of the Monetary Policy Committee (MPC) 3 of the 8 members voted for a rise. There is a fine balance to be maintained; raise rates too aggressively and demand may fall too much and push the economy into a recession, don't raise and the Bank of England may be behind the curve, that is raising rates to catch up and control inflation. Any increase is likely to be modest. Perhaps a reversal of the 0.25% cut post the Brexit referendum.

UK household saving ratio



Across the Atlantic the hiking of rates proceeds apace with another rise in June. Rates are now at 1.25%, the third increase. Why? Job growth has lowered unemployment to its lowest level in 16 years along with moderate economic activity and rises in household spending. More rises are forecast in 2017 and 2018. For the moment the Trump legislation blitz appears to be stalling and less has been heard of tax reform and infrastructure spending.

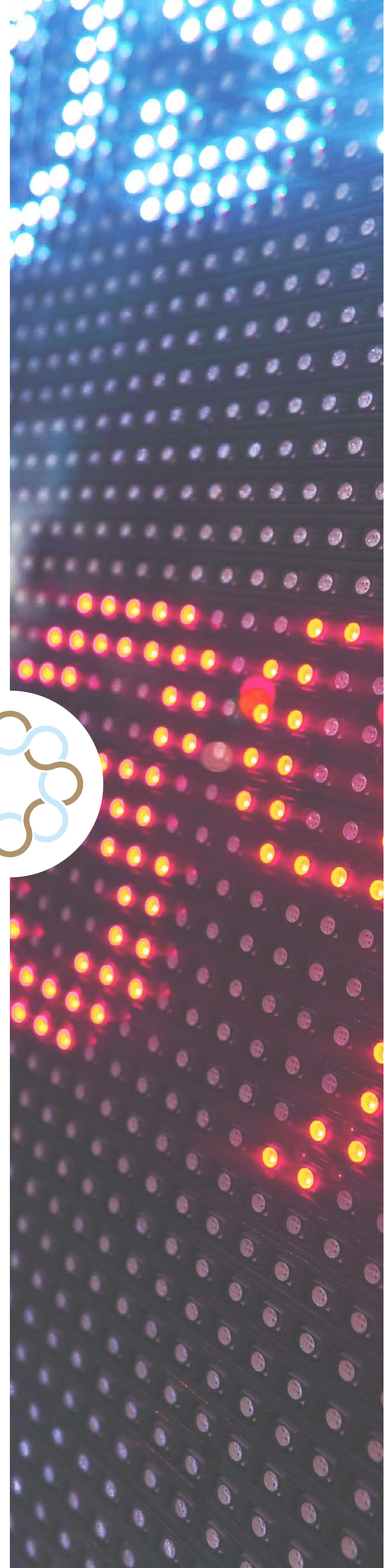
Meanwhile in Europe, the convincing victory of Macron in France has been welcomed by markets and seen as a positive for mainstream Europe. The FTSE Developed Europe ex UK index was the best performing major market in the second quarter, up 4.95% in sterling terms.

Given his majority in Parliament, it appears Macron has a mandate for radical change in French labour laws, and hopefully reducing the high unemployment. Whether in practice this can be achieved remains a moot point. Watch this space.

And finally, geopolitics remains a possible flashpoint that may cause stock markets problems. North Korea remains a concern and the standoff between Saudi Arabia and its neighbour Qatar has yet to be resolved. Either may provide an unpleasant shock to the status quo.

As always in such uncertain times it is timely to remind investors to remain comfortable with the level of risk and reward within their portfolios. The rest of 2017 may yet spring a few more surprises!

First published on 10th August 2017 by Simon Brett, Director & Chief Investment Officer at Parmenion Investment Management.



EUROPE EN MARCHE!

In similar fashion to last year, June concluded with some large swings in equity and bond markets. But rather than the perpetrator being the collective voice of the UK public, this time it was the hawkish words of Central Bankers that caused a reaction.

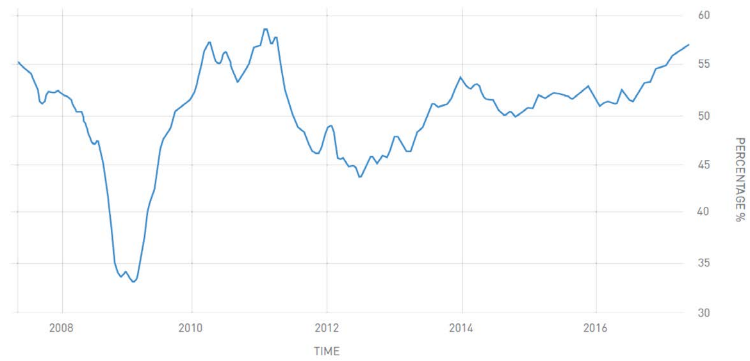
At the centre was Mario Draghi and his proclamation that deflation was over and rather an era of reflation had dawned. Whether these words were wise or not can be debated. Perhaps the additional ECB statement that followed indicates they at least weren't received as intended. What is clearer are the circumstances that led to these positive comments; Europe has been the positive surprise of 2017 thus far.

Political uncertainty and Europe have been synonymous with each other of late. However, with victory for Emmanuel Macron's En Marche party and defeat for the Freedom Party in the Netherlands, the tide of populism has somewhat subsided. Notwithstanding Italy and Germany, where elections are still to come, for many the removal of these political headwinds has contributed to making Europe a much more viable place to invest, as can be seen by recent inflows to the asset class.

Compared to the US, for example, Europe is in the infant stage of recovery. This is reflected in both economic data and stock market valuations, where companies are generally cheaper as per price-to-earning and price-to-book ratios. While being in the early stage of a recovery can provide ample growth opportunities it is not without uncertainty, and the manner in which it will manifest across so many differing countries is unknown.

That said, overall indicators for the region have been encouraging for a while now; unemployment has continued to fall, both inflation and wage growth have consistently stayed above 1%, and Euro Area economic activity in June grew at its fastest rate since April 2011 (as per Manufacturing PMI).

Euro Area Manufacturing PMI

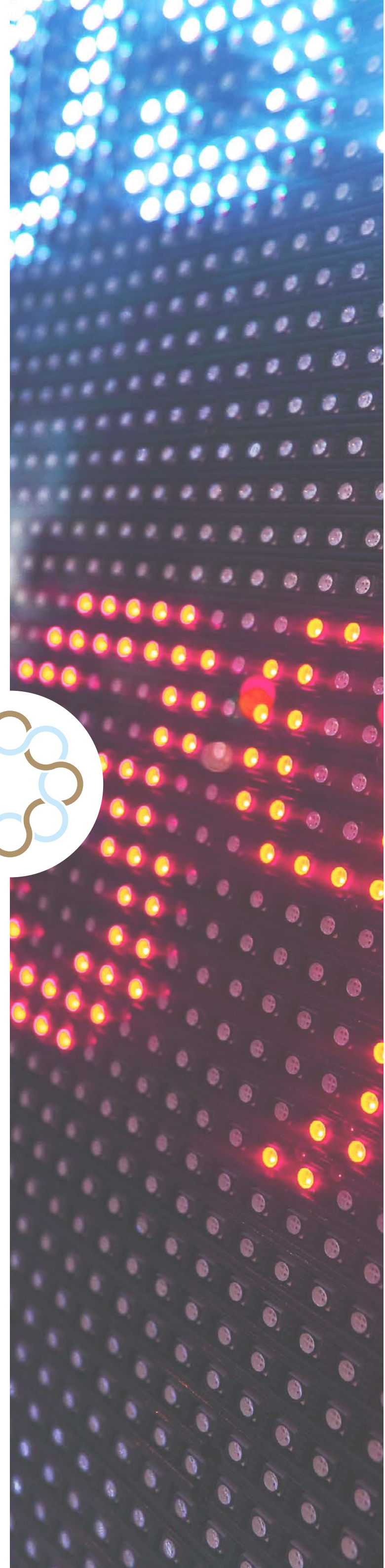


Source: Trading Economics, 2017

This has all fed confidence into the market, with the FTSE Europe ex UK index returning 12.01% compared to 5.41% for the FTSE World ex Eurobloc over the first 6 months of the year. However, the strongest test of European resilience will likely come when the ECB begin to reduce their Bond buying activity. This has reduced and kept interest rates low, encouraging investment and growth. With 2018 as the consensus start date for this first step in policy tightening, the extent of the European recovery will be measured by its ability to absorb this reduction in stimulus.

Whether the decline in European populism persists will likely hinge on the extent to which the economic recovery feeds through the whole population. Continuously improving fundamentals should bring more political stability and this can only enhance the investment attraction of the region.

First published on 10th August 2017 by Jasper Thornton-Boelman, Investment Analyst at Parmenion Investment Management.



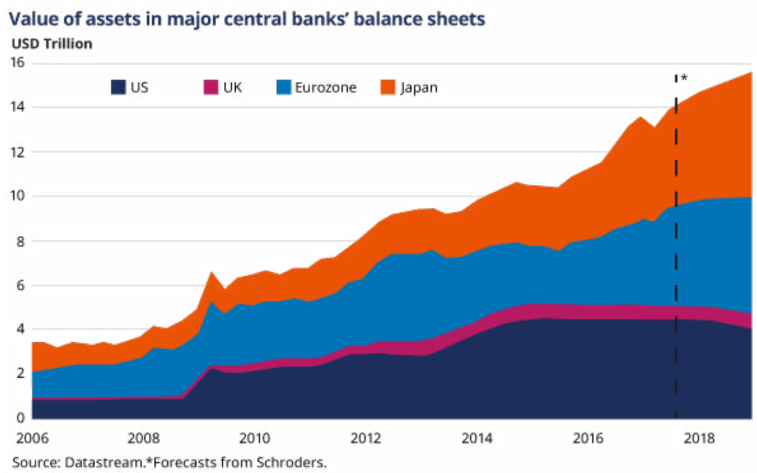
MOVING ON… FIVE-YEAR ANNIVERSARY OF MR DRAGHI'S "WHATEVER IT TAKES"

Against the backdrop of duller business cycles and at times mixed signals from economic data, financial markets have become increasingly sensitive to remarks and speeches from policymakers.

An interesting development recently emerged in Sintra at the European Central Bank (ECB) Forum on Central Banking. Surprisingly, the event was marked by the emergence of a more hawkish tone in the rhetoric of the major central banks, a seemingly deliberate and coordinated act. Mr Draghi of the ECB and Mr Carney of the Bank of England both made hawkish remarks despite being renowned for their accommodative bias and inflation tolerance.

The beginning of an end of ultra-loose ('unconventional') monetary policy started with the Federal Reserve's (Fed) Quantitative Easing (QE) taper in 2014. More obviously, the process of interest rate normalisation began at the end of 2015, and to date, the Fed has raised four times. Thus, the Fed has taken the lead in policy normalisation, reflecting the economy's more mature position in the business cycle (certainly when compared to the eurozone, although not perhaps in relation to the UK) with other major central banks remaining in wait-and-see mode.

In July, the Bank of Canada became the first Group of Seven (G7) central bank to join the Fed in raising rates in the current cycle, the first time it had changed rates since 2010. With synchronised global growth being a key macro theme this year, the question is whether synchronised policy normalisation will emerge as well. We think the bottom line is that the period of exceptional monetary stimulus is coming to an end and interest rates are going up, albeit gradually.

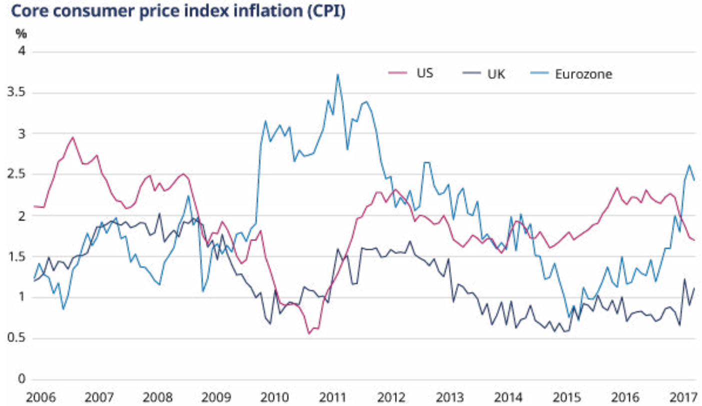


United States

The Federal Open Market Committee (FOMC) raised rates as expected and kept rate projections largely unchanged in June, attributing the downward drift in core consumer price inflation (CPI) to transitory factors. Fast forward a month, Fed Chair Janet Yellen's testimony to the Congress revealed greater uncertainty over the future course of core inflation as it continues to run below the committee's 2% longer-run objective. Mrs Yellen emphasised inflation as a key uncertainty and so too fiscal policy. She said that there is "uncertainty about when – and how much – inflation will respond to tightening resource utilization" and that this will remain a key focus for the Fed in the near term. This remark reflects the uncertainty caused by continuing weak wage growth despite robust employment gains and rising recruitment difficulties. The bottom line is that a gradual pace of policy normalisation is likely to remain the direction of travel but that lower inflation is receiving closer scrutiny, and any further weakness may lead the FOMC to hesitate in its projected normalisation process.

Following its June meeting, the Federal Reserve shed more light on potential balance sheet normalisation, and something that also received attention in Mrs Yellen's testimony. If economic data evolves as expected, "quantitative tightening" will likely be announced as early as in September. The reduction in QE will be done in a gradual way, achieved by not reinvesting a small portion of the monies received from maturing assets. Nonetheless, even though the Fed anticipates reducing the quantity of reserve balances to a level that is below current levels, reserves will remain considerably higher than before the financial crisis.

Core consumer price index inflation (CPI)



Source: Datastream

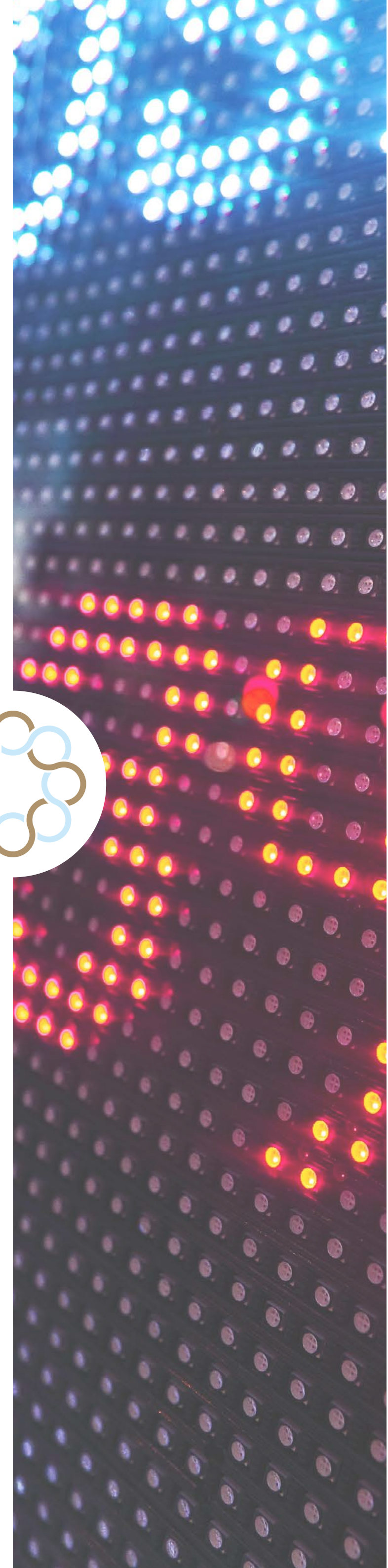
Eurozone

In an interesting development, Mr Draghi's speech at Sintra prompted markets to focus on the possibility of a turning point in monetary policy in the Eurozone. There was a decisive change in Mr Draghi's tone when compared to his renowned "whatever it takes" speech at the height of the Eurozone debt crisis. Five years on at Sintra, he said "as the economy continues to recover, a constant policy stance will become accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged".

On the economy, Mr Draghi sounded upbeat: "all the signs now point to a strengthening and broadening recovery in the Euro area" and that "deflationary forces have been replaced by reflationary ones". Indeed, the cyclical recovery in the Eurozone has become more robust with first quarter GDP growth outpacing that in both the US and the UK.

Importantly, growth is now more broad-based in terms of regions and sectors. Behind this, business activity indicators have risen to their best level in six years and consumer confidence has surged to the highest level in 16 years. At the same time, political headwinds have turned into tailwinds and conditions in the labour market have continued to improve.

Despite this better growth momentum, core inflation has remained subdued and at a rate that is around half of the ECB's 2% target. Despite the better position of the real



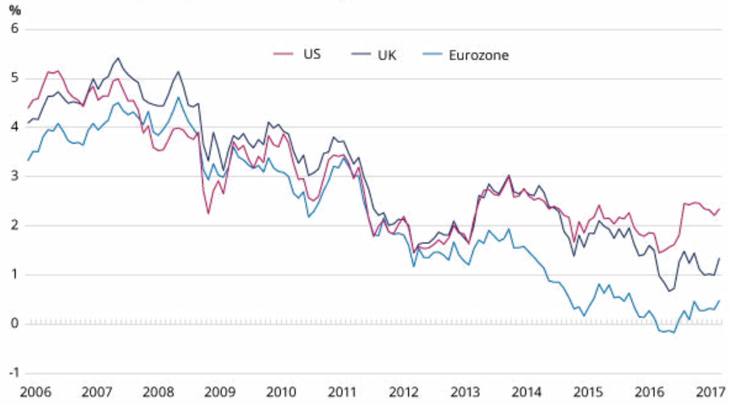
economy, renewed weakness in oil prices and persistent structural issues may well cause the ECB to reconsider its apparent shift in thinking towards policy normalisation. The bottom line is that ultra-accommodative measures are no longer justified, but the ECB is likely to change its stance only gradually and cautiously.

United Kingdom

The debate on monetary policy normalisation in the UK is complicated by the trade off between weaker growth and overshooting inflation against the backdrop of Brexit uncertainty. Despite further evidence of a slowdown in real wage growth and heightened uncertainty after the general election, the Monetary Policy Committee (MPC) surprised markets with only a 5-3 vote on keeping policy unchanged in June.

After the Bank of England (BOE) Chief Economist suggested that a policy change might be appropriate in the second half of the year, Mr Carney's remarks at Sintra fuelled further speculation that the BOE has started moving closer to a rate increase. Mr Carney said "some removal of monetary stimulus is likely to become necessary if the trade-off facing the MPC continues to lessen and the policy decision accordingly becomes more conventional".

Benchmark 10-year government bond yields



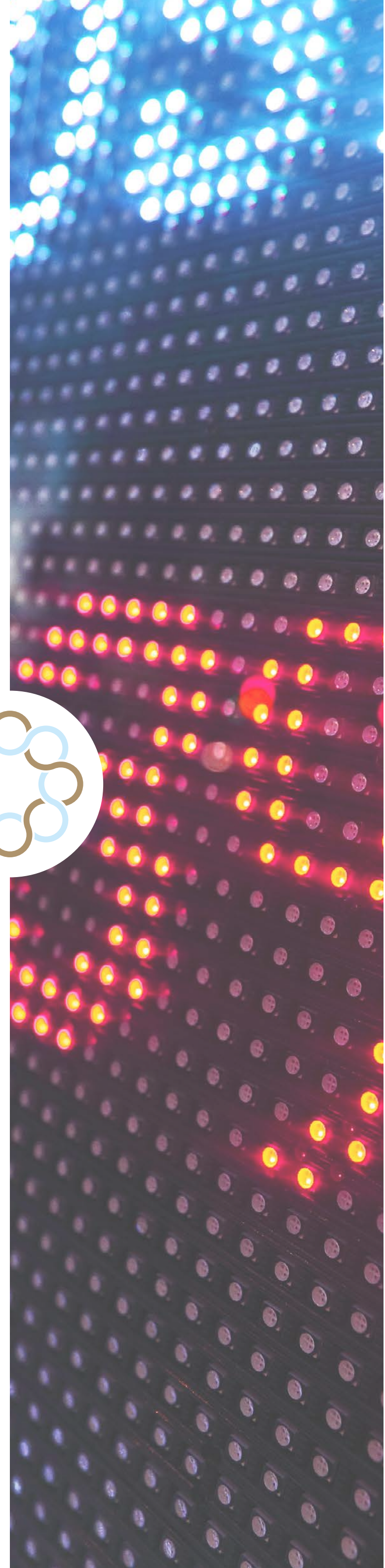
Source: Datastream

While we acknowledge the high chance that Bank rates will rise by the end of the year, we think the bar for policy normalisation remains high. Any decision to hike rates will be contingent on the extent to which weaker consumption growth is offset by other demand components and also on how the UK economy reacts to tighter financial conditions and Brexit negotiations.

So far, there is little evidence that net trade and investment will move the dial as much as hoped, and recent figures for industrial production and trade have looked disappointing. A potentially weak second quarter GDP report and a slight (albeit probably temporary) reduction in inflation may dissuade the more hawkish MPC members from continuing to vote for a rate rise.

Notwithstanding the intense debates that are clearly underway within the walls of the world's central banks and continuing reluctance to risk stifling growth, our take is that the debate on synchronisation in monetary policy normalisation is heating up. Despite forward guidance and communication from central banks, developments over recent weeks suggest that bond markets have not fully discounted the potential mood change, giving rise to the possibility that bond yields could rise sharply. We know from past experience that expectations can adjust quickly, and investors should be increasingly aware of the risks in fixed income.

First published on 21st July 2017 by Janet Mui, Global Economist at Cazenove Capital Management.



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