GLOBAL MARKETS BULLETIN

Quarter 2: 2016

CHESHIRE
WEALTH MANAGEMENT

General Economic Overview

It would be relatively easy to focus on just one event in this quarterly view – the impact of the EU referendum result – as it has clearly dominated debate in the press and in most company board rooms during the latter part of the quarter. Brexit has had a short term impact on volatility in markets but remarkably, after the immediate falls in global markets, the recovery in the week following the vote was robust and resulted in the FTSE 100 index being at a 2016 high. This has masked somewhat the underlying fundamental concerns that had driven markets in the proceeding five months of 2016 – the slowing global growth environment and the lack of inflation and wage growth had a further negative effect on global growth at a time of increasing uncertainty. Markets entered the Brexit vote towards the highs of recent trading ranges and at a time when many equity market valuations in absolute terms looked expensive relative to 10 year history. We are still in a world where both real and perhaps even more importantly nominal GDP growth have converged at low levels, an environment that has clearly made it difficult for businesses, especially cyclical ones, to deliver strong profits growth as pricing power has diminished. When nominal GDP is 5% cyclicals have the ability to raise prices each year, something that does not occur when nominal GDP is in the 1% - 2% range. Investors had hoped that 2016 would see a continued catch-up for the European and Japanese stock markets which had significantly lagged the US in the post 2009 recovery period – for Japan these hopes have been shattered by the strength of the Yen, whilst political and economic uncertainty for Europe means hopes for a proper recovery cycle will have to be pushed out further.

For many investors Friday 24th June was about short term noise, market reaction and sentiment but for longer term investors, taking a reasoned view on the implications of the Brexit vote is much more important. Our reviews have always looked to provide investors with a longer term perspective on investment markets and the global economy, and investors need to decide whether the Brexit vote has caused a longer term change to the future course of asset markets. There will clearly be a period of uncertainty going forward and how long this lasts will depend on the speed at which the UK can re-shape its trading arrangements not only with Europe, but also with the rest of the world.

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When looking at markets, investors need to focus on what is priced in and what is not, as valuation at the point of entry is likely to be an important driver of returns over the next decade. In our April outlook we reminded investors that whilst recessionary fears in the early weeks of the year were overdone, the global economy remained trapped in a low growth world where profit growth would be muted. In fact, earnings expectations for 2016 have been further trimmed back to, at best, extremely low single digit increases in most major markets, whilst some were already expecting a 2016 decline. Sell side analysts were far more optimistic for 2017, predicting a rebound in corporate earnings in double digits, admittedly with much of the expected improvement next year driven by energy and financials. Whilst improvements in the profitability of energy companies are likely to increase from 2016, a slowdown in the global economy and lower oil price would impact negatively. One of the larger sectoral adjustments to earnings forecasts is likely to occur in financials where analysts had expected positive factors such as modestly rising interest rates and bond yields and a steepening yield curve to benefit not only banks, but also insurance companies – these forecasts are now likely to be cut. At the regional level the US and especially Japan will see a negative impact from a stronger currency on profit forecasts. If the US currency were to strengthen substantially, something the US Federal Reserve is likely to guard against, this would be a significant negative for both Asia and the wider emerging markets.

The year so far has been relatively positive, with returns reflecting higher levels of volatility and of course the effects of Brexit. The main market issues have been sentiment based as investors have focused on negative information at the beginning of the year followed by a recovery which saw support of energy and mining stocks and then the subsequent focus on Brexit. The fundamentals of a slowing growth environment has meant that whilst a number of markets are ahead this year they have remained stubbornly within a trading range. It would appear this may be difficult to break out of unless we see better earnings growth figures, which seems unlikely at the moment.

UK

Whilst the UK is clearly the market most affected by the Brexit vote, it did manage to recover quite strongly in the week following the vote. There are clearly concerns about the long term impact of leaving the EU, and a closer look at UK companies reveals that the strength in markets following the vote has been more focused on the larger cap area of the market and in particular overseas earners who are less affected by falls in sterling.

Following the referendum vote, we saw a fall in the value of sterling which has both positive and negative connotations in the short and long term. The positive is of course that UK goods become more competitive which is positive for exports, however imports become more expensive which is negative for our current accounts balance and in the short term could have the effect of increasing inflation above target.

The UK economy was, like the rest of the world, looking towards a lower growth environment for the coming twelve months as global growth slowed, but earnings forecasts for UK companies have also reduced and unless this can stabilise or improve, market valuation levels are unlikely to move on to a higher trading range.

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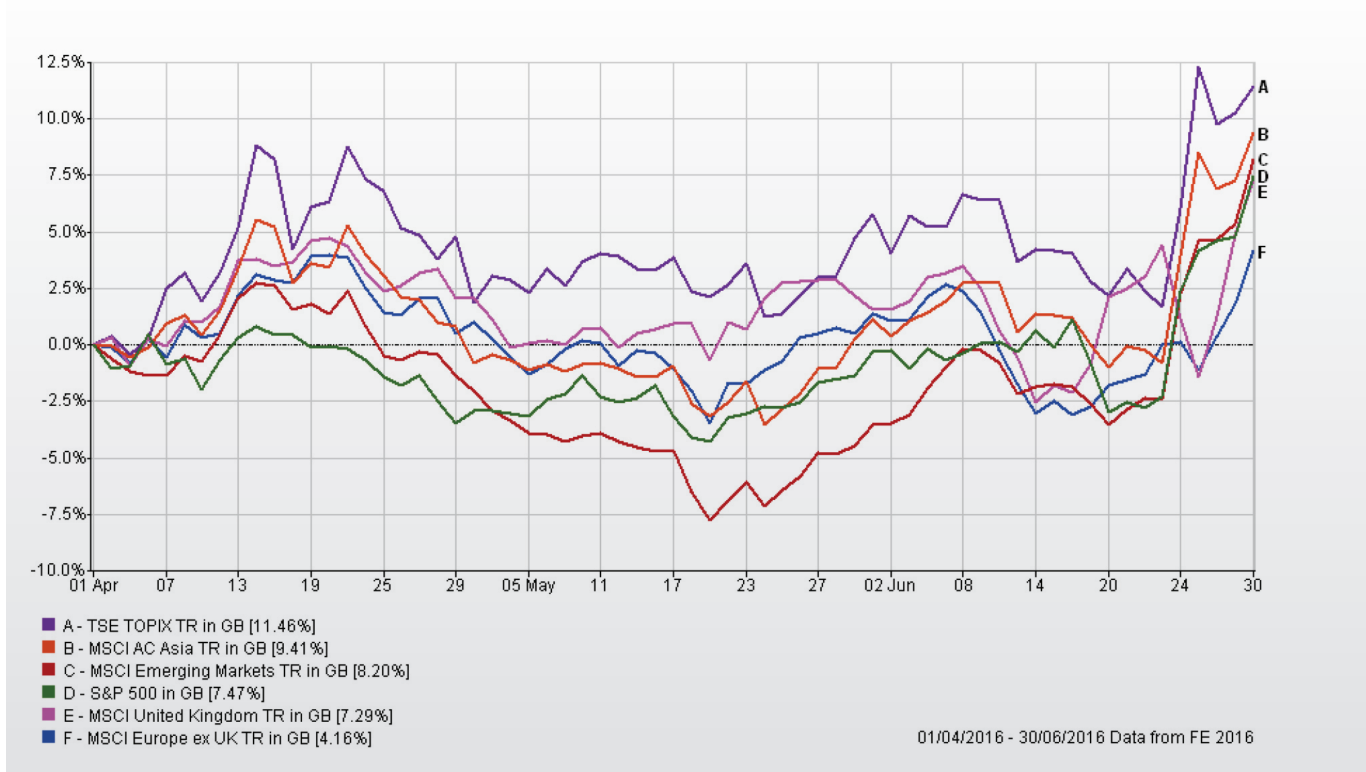
Equity Markets Overview

Chart showing 2015 returns for major market indices:

Chart showing Q2 2016 returns for major market indices:



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The returns from the broader market this quarter have been surprisingly strong and this has meant that despite the poor start to the year we have seen a recovery of sorts although this has not been a universal recovery. Areas hit hardest include banks and housebuilders and they have not recovered in the way that less cyclically biased stocks have done. The near future of the UK will be dominated by political uncertainty and then the focus will move onto the practicalities of exiting the EU and the trade deals that can be struck. It is therefore difficult to look longer term in such an environment but investors need to do so to avoid snap decisions based on sentiment led market movements.

US

As with most markets the quarter has been overshadowed by the reaction to the Brexit vote but in reality the US is less vulnerable to this decision than most global markets given its domestic bias. The fear of global contagion and an early cyclical recession is not a consensus opinion in the US with many feeling that now the EU vote is out of the way it will allow investor to focus once more on more fundamental issues. Winners include most of what has been doing well since the 2008-09 financial crisis: bonds, utilities and staples, as upward pressure on rates is currently absent. Losers in the short term are some of the areas that have done better since mid-February, such as energy, materials, and industrials (which were hit pretty hard shortly after the vote). Financials are under pressure due to the drop in bond yields. The US remains the strongest western economy although valuations are at the higher end of analyst expectations based on current earnings levels. A worry for the US is that with corporates seeing profitability under pressure across many sectors they may respond to this by looking to cut costs through laying off workers. The next recession in the US as and when it does occur is likely to be triggered by this event, although even with the shock of Brexit it would be rash for investors to assume with any level of certainty this will occur over the next 12 months.

Europe

The UK and Europe are now at the beginning of an extended period of uncertainty which may flow over into the global economy. The extent of political concerns about stresses in the Eurozone's periphery was demonstrated by the significant declines in southern European stock markets - the Spanish market fell by just over 12%, as did Italy, and 10 year bond yields in Italy rose by 30bp to 1.53%.

Political ramifications are likely to spread further than the UK, with anti-Europe parties within other Euro Zone members demanding a Referendum or pressing for an exit. Concerns about a potential breakup of the Euro project were reflected in significantly wider bond spreads in peripheral European markets. In stock markets, shares in airlines, banks, travel companies and media groups were hit the hardest, whilst consumer staples and healthcare performed relatively well. Banks globally were hit, not just in the UK, with the Euro Stoxx Bank Index falling by around 17%.

Politically Europe has a number of issues to deal with following the Brexit vote as the Union is under threat from right wing opposition – somewhat perversely, the UK leaving may strengthen the resolve of the others to stay united given the immediate political and economic concerns that the exit vote has brought up in the UK. Any global slowdown will affect European companies but the general state of core and peripheral economies is much stronger than after the global financial crisis and with the ECB maintaining easy monetary policy and QE, a significant recession looks unlikely.

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Asia

The change in tack by the Federal Reserve with a significant push back on expectations of US rate rises has aided the Asian markets this year. There have also been signs of stabilisation in the Chinese economy following the economic stimulus, although this means dealing with longer-term issues has been put on hold. In Indonesia macro and corporate news has been positive and in Thailand the markets exposure to oil and gas names has proved a positive. In India, company results have disappointed in industrials, whilst the consumer sector is more buoyant – reform to the economy has taken longer to come through than expected, but the position of the BJP has been strengthened by positive state elections. The Philippines election result has been viewed favourably by the market.

China continues to have a significant influence on the region's markets, as it does on global markets, and concerns remain about the influence of their current economic slowdown. Economic data continues to evidence this slowdown and investor expectations are generally for weaker growth over the next 12 months, so GDP may struggle to hit the government's target of 6.5% - 7%. This is still a strong number but much lower than the average over the recent past, although this is to be expected as the economy develops and becomes more mature, and continues to undertake a general rebalancing away from manufacturing-led activity and towards consumption and services-led activity. Another concern, partly related, is the Chinese yuan, as investors are concerned that there will be a systematic weakening of the currency, which has led to capital outflows from China and will make other countries' exports less competitive. The authorities have stated that it is not their current intention to specifically devalue their currency.

The main argument in favour of the region is valuation, with both PE ratios and price to book valuations trading at discounts to longer term averages and this valuation gap is in marked contrast to most developed markets. India continues to be a market with excellent longer term potential if reforms continue and Asia is a beneficiary of the falls in commodity prices that have occurred. The flight to safe haven assets in the wake of the Brexit vote has hampered these economies in the sense that a stronger dollar does not help those countries with high debt to GDP ratios, however most economies in the region are less exposed than some emerging markets.

Japan

The strength of the currency has been a positive for sterling investors. Valuations remain attractive relative to their history, particularly on a Price to Book basis but without a further weakening in the currency, there needs to be greater concentration on unlocking shareholder value and corporate governance. Further positive market movements depend on foreign investors re-entering the market and signs that the government and the Bank of Japan's policies can lead Japan into a period of sustained economic growth. In 2016 Japan, like other markets, has seen defensive shares out-perform cyclicals and for this trend to reverse the market needs to see an end to negative bond yields which is very damaging to the banking and insurance sectors.

Corporate governance is also on an upward trend leading to greater capital efficiency, and total dividends paid by listed companies will rise by over 10% for the sixth straight year. All these factors are seen as positive but caution is still required as there are still many uncompetitive companies failing to adapt to this new environment.

There is some evidence that the Abenomics experiment is running out of steam with the recent sale of 10 year bonds, at a government auction, at yields below zero for the first time. This is reflective of a collapse in borrowing costs globally as central banks take evermore unusual steps to stimulate growth. Japan has become the second country after Switzerland to do this and it looks increasingly as if the government are resorting to more extreme measures to stimulate the required growth. The structural reform programme continues, but it needs to achieve greater acceptance across a wider base of companies and domestic investors to keep the momentum. Inflation has been achieved but not yet at the levels set by the government and this remains a goal that they need to maintain. 2016 has seen market momentum reverse, which is the same for most markets around the world, as investor fear has taken markets to new levels of

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volatility. Abenomics has certainly come under greater scrutiny in the last six months over the effectiveness of policies to stimulate growth and inflation and this will only increase if policymakers continue to take more extreme measures to achieve this.

Emerging Markets

Emerging markets have had another good quarter, in part due to the relative strength of the currencies compared to sterling, particularly at the end of the quarter due to the Brexit vote.

The three core issues affecting emerging markets over 2015 were the strength of the dollar, commodity prices and lower levels of profitability. This has changed in 2016 with the improvement in commodity prices and slowing of dollar strength. Corporate profitability is still in need of improvement, particularly in China in areas such as steel glass and cement. The price to book ratios for many EM companies is still attractive at around 1.25x book value and in previous periods when it has been at this level, returns have been strong over the following twelve months.

There is also a marked contrast between companies benefitting from the strength of the service sector such as outbound tourism and increased levels of consumer spending, compared to those countries / companies reliant on strength in commodity prices. China has a significant effect on this region, most obviously on commodity exporting nations such as Australia and Brazil, and many of these countries slackened off on the reform process during the commodity super cycle and are now having to re-trench more aggressively.

Brazil still suffers from weaker commodity prices as far as the current account deficit is concerned but the market has recovered well for sterling investors being up 22 % to the end of June. There is of course some political uncertainty as the current President is impeached and a temporary one is in place but the outlook is more positive.

Other markets in Latin America have benefitted either from political change such as Argentina, or a bounce in the oil price in the case of Mexico. The rally in the oil price has benefited Russia and companies who generate revenue in US$ revenue but have costs denominated in the local currency. Eastern Europe

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had benefitted from the more positive backdrop to European economies before the Brexit decision.

Emerging Markets have been helped by the belief that an aggressive tightening of US monetary policy will not occur, easing pressure on currencies. The main argument in favour of the Global Emerging Markets sector is valuation with both PE ratios and price to book valuations trading at discounts to longer term averages. Clearly the Brexit vote whilst not significant to most GEM countries will have ramifications if it creates more global and economic uncertainty, particularly if we see further dollar strength.

The strength of bond markets continues to surprise some investors but we should reflect on the fact that we are now in a period of slowing growth as well as loose monetary policy and quantitative easing. This combination has continued to keep interest rates low much to the chagrin of some central banks, including the Fed which has more recently pursued a more globally inclusive perspective on rate rises. Although most economies have come out of recession and were growing again from 2010

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Fixed Interest

Chart showing 2016 returns for major market indices:

Chart showing Q2 2016 returns for major market indices:

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onwards the growth has been slow and fragile with a number of anomalies causing concern amongst investors. This has led to frequent flights to safety and to a position where negative yields can now attract investors. The sovereign debt market has proven to be a useful source of return for investors in 2016 with investors prepared to risk a limited level of return and small yield for the security of capital. In the UK ten year gilts have fallen to below 1.5% in the recent Brexit crisis illustrating the continued demand for safe haven assets, with gilts having returned over 10% for sterling investors this year despite a relatively low starting point. Following the recent vote result the 10 year US Treasury yield has fallen by 25bps – a move of more than two percentage points in capital terms. The 10 year German bund yield has traded at a record low of -15bps (whilst it seems counter intuitive to lend money to Germany at negative rates, it might be worth considering the likely currency moves if Germany moved back to the Deutschmark on a Euro breakup). Markets are now pricing in interest rates that remain lower for longer with a rate cut possible from the Bank of England perhaps to 0% from the current 0.5% over the coming months. Emerging market debt has had a good year until very recently.

Corporate debt is slightly less attractive but if spreads tighten, particularly in the high yield market, there may well be some good opportunities in this area as well. Initially corporate credit spreads rose, especially in peripheral financial bonds where spreads have widened by 60bps at the senior level and up to 130bps at the subordinated level. The selloff in the high yield market was at its worst initially with the Crossover Index at one stage 120bps wider, but it has now regained some of these losses. Institutional demand for corporate credit is likely to remain strong at the investment grade level, especially in an environment of ECB corporate bond buying due to its QE programme.

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Property

The commercial property market also suffered because of the uncertainty around the threat of Brexit, and this situation has been compounded following the vote. A number of physical property funds have recently introduced a fair value adjustment for those wishing to exit a fund and over the last few days some have suspended trading. This suggests that the property market is weakening in demand terms and that the requirement for liquidity in funds has increased.

The property market has been a good source of return in recent years both from a capital and income perspective and direct property should continue to be a good diversifying asset class with returns driven mainly by income. Capital growth returns are expected to continue weakening (potentially speeded up by Brexit) with rental growth becoming a larger driver of total returns.

There remain concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven, although overseas interest has waned recently. The yield gap for secondary markets versus prime property remains attractive but individual property selection will remain important here. Returns from UK commercial property are expected to remain stable but lower than the previous few years, and the vote to exit the EU has lowered expectations. This is perhaps one of the reasons why investors have begun to reduce their exposure to property funds, leading to the pricing changes – many investors have been overweight commercial property for some time and with the reduction in expected returns some are choosing to take profits and reduce their allocations, which is not necessarily a negative view on the asset class as a whole. Investors are still looking for an income alternative to some of their fixed income allocation and the expected returns should continue to attract investors once the immediate volatility following Brexit has reduced.

"This suggests that the property market is weakening in demand terms and that the requirement for liquidity in funds has increased."

The property securities sector continues to be influenced by the outlook for interest rates (as expectations for rate rises are generally negative for the sector), economic growth levels and the outlook for property and equity markets in general. The results of the EU vote had a negative effect on prices in the UK and although there has been some recovery, the overall year to date figures are negative (pre Brexit it was flat). Investor sentiment and valuation levels are likely to be influenced by these factors over the short-term, which has changed the view on interest rate rises for the rest of the year, which may now turn out to be marginally positive for the sector.

It will be interesting to see how the REIT / property securities sector reacts to future news, both positive and negative from here. This will also have an influence on non-US REIT markets, however local market factors typically have a larger influence on this sector than for the main equity indices and these should also be taken into consideration.

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Summary

The recent quarter's events have proven to be more dramatic than the polls had predicted with the investment world taken by surprise when the UK population voted to exit the EU. Although this dominated the press before and after the 23rd of June, the fundamental issues affecting the world's economies did not change in the quarter but perhaps tilted more negatively.

June valuation levels mean investors are faced with the same dilemma that has been in place for much of the last 18 months. Markets have front run the recovery and are still not cheaply valued, with the US in particular trading at levels that are expensive when looking at historic valuations or trend earnings. A worry for the US is that with corporates seeing profitability under pressure across many sectors they may respond by looking to cut costs through laying off workers – something likely to trigger the next US recession, although even with the shock of the UK's EU exit, it would be rash for investors to assume with any level of certainty this will occur over the next 12 months. High valuations in markets are occurring at a time when corporate earnings growth is muted, which demonstrates how important a low interest rate world has become to market valuations and with rates likely to stay lower for longer some parts of the stock market will be favoured over others. A world of low growth is likely to become a world of slightly lower growth, favouring bond proxies and economically insensitive stocks which feature heavily in many of the lower risk equity funds which have been recommended to investors over the last 12 months.

While the prospects for equity returns remain muted over the next few years, other obviously attractively valued asset classes remain difficult to find. The spike down in government bond yields, whilst reflecting a lower for longer rates environment, also represents a strong risk off mood in the markets. Unless Brexit impacts so negatively on corporate confidence that a recession occurs, it is hard to find fundamental support for government bonds at current levels. The widening of investment grade credit spreads does mean this asset class looks attractive against cash over the next 12 months and even though the high yield market is more susceptible to economic uncertainty, the thirst for yield will only increase in today's interest rate environment. As risks have increased, investors should choose managers with proven research skills in the corporate bond market, both in investment grade and especially in the high yield area.

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The world and stock markets are a riskier place following the EU vote, at a time when economic risks post the global financial crisis were still elevated. Heightened uncertainty is likely to affect both corporates and individuals negatively, making them more cautious in a world already showing signs of demand deficiency. The exit from unconventional monetary policy has moved further away with all this means for stock markets, and banks in particular.

Longer term investors still face the challenge of trying to generate reasonable returns ahead of cash to meet retirement or saving objectives and selective exposure to equities should still be taken. It could be argued that recent events only reinforce the attractiveness of lower risk equity funds where the managers focus on delivering a positive return and ignore benchmark indices. These continue to have the prospect of delivering reasonable returns ahead of cash (which may now be a cumulative zero) over rolling five year periods. Clearly manager skill and understanding corporate balance sheets and growth prospects is more crucial than ever. We commented before that investors will have to live with higher levels of volatility than in the early recovery period and this is not going to alter.

Whilst the task ahead is not easy, there are a number of managers with proven skills of operating in difficult macro circumstances and it is these funds that should be at the core of investor portfolios today.

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July 2016

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