Monthly Investment Review – February 2017

Macro Outlook

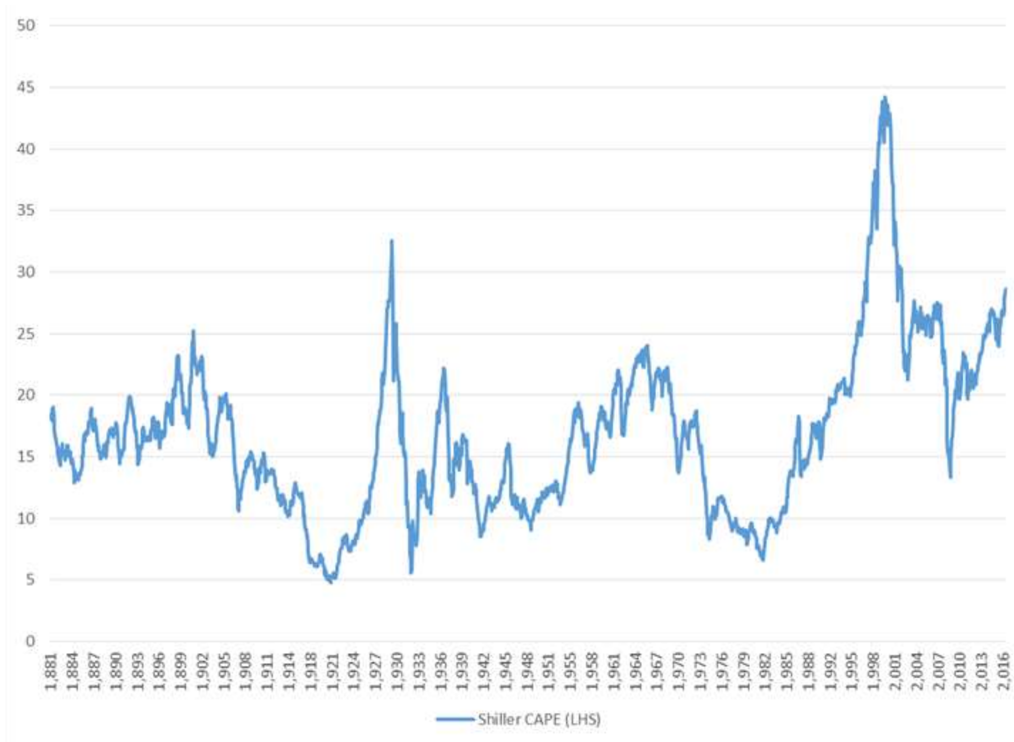
Sweet spot?

February was a positive month and our balanced portfolio outperformed its benchmark by approximately 65 bps. The outperformance was driven, for the most part, by our equity options which steered the performance of our equity exposure. The main attraction for the use of derivatives is the asymmetrical exposure. When we renew our exposure (as we did last December) we strike our options very close to the current spot and this has two major consequences. As indices rise and go beyond the strike price, the acceleration of option price appreciation is at its maximum. Also as options become more "in the money", our portfolios are automatically tilted towards the best performing market. This happened in February and explains most of our equity performance. Equity markets rose due to continued positive macro data in Europe and in the US and had an ultimate boost during the last day of the month, as President Trump addressed the Congress. Other asset classes performed well, one of our structured products expired and yielded a 4% coupon after only having held it for one month.

The recent equity rally brings us to our next question: have equity markets gone up too much? Are equities too expensive? Since Donald Trump was elected to the end of February, the S&P 500 is up 11.21%. Since the beginning of the year to the end of February, it is up 5.57%. Adding 2% dividends to this performance, and assuming the S&P does nothing for the rest of the year, it would be up by more than 7.5%. Quite impressive for just two months. The question is: how long can it last? One of the side effects of price distortion by central banks since the financial crisis is that you can easily argue for both sides.

On the expensive side, the S&P is currently trading at multiples (Price Earnings or PE ratio, a measure of how expensive the stock market is) last seen in 2003, and the long term PE (the Shiller Cyclically Adjusted PE) is trading at an all-time highs as seen in the graph source: yale.edu). There is also a view that this cycle is longer than the average cycle of the 20th century, and that the latest upside movement is mainly due to expectations that the new administration in the US will give the economy a new impetus, but so far nothing has materialised.

Chart 1: S&P CAPE since 1880



Source: yale.edu

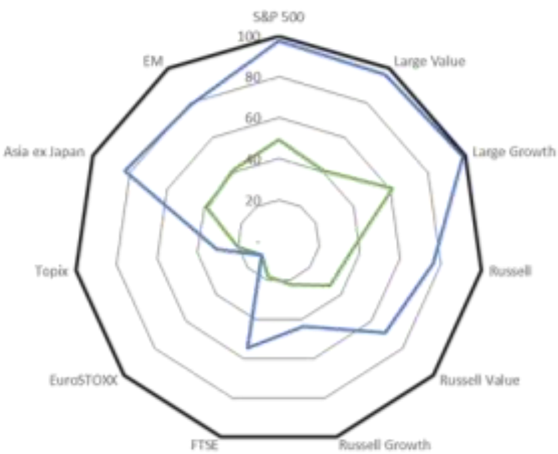
On the other side, an argument could be made that for the first time in over two years, the earnings recession that took place in the US has ended, and that company earnings are about to grow. The graph below shows that for 2017, earnings per share are expected to reach $130, which provides a more reasonable PE of 18x.

Chart 2: Changes for S&P

Source: Bloomberg

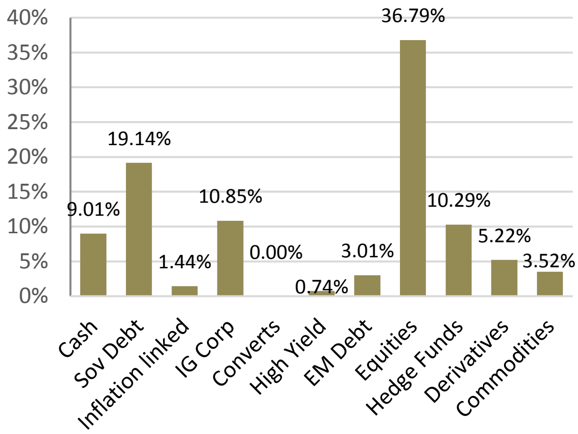
The key point is that these earnings are mainly due to a pick-up in earnings in energy, mining and the banking sectors and has nothing to do with potential reforms in the US. Last but not least, many asset managers seem to share the view that equity markets have risen too quickly and that therefore such a trend is not sustainable. The issue with this argument is that an equity correction seldom happens when everyone is expecting it. The periods of August - September 2015 and January - February 2016 are a painful reminder of how sharp corrections can be when asset managers are taken by surprise. Conversely, many people expected the 4th quarter of 2016 to be very volatile, protection strategies were very much in demand, and then nothing happened.

We look at it in a slightly different way. The graph below shows the PE ratio for different markets, in grey the median value over the last 5 years, in blue the latest value and in black the highest value over the past five years. While there is no denying that US valuations are high, valuations from the rest of the world are far from stretched, thus indicating that there are still pockets of value in some equity markets.



What will we do in such an environment? Rather than trying to predict how markets will perform over the next few months, we are going to take advantage of some of our options expiring in March and sell some positions and restrike some. This will enable us to partially take profit and reduce our equity position. Should markets continue to rise, we will moderately underperform as we did in January however, if they continue to rise, we will catch up and if they fall, our portfolios will suffer less due to a lower equity positioning and we will have protected some of our gains.

Chart 3: February Balanced Mandate Asset Allocation



Source: Signia Wealth

Funds

The broadly strong performance of our fund managers continued through February, as the dispersion of equity returns rose back to healthier levels. Those funds with growth or defensive styles have helped performance whilst value strategies detracted from performance slightly. For example, Global Funds blend with the quality compounding names of Fundsmith surged over 2.3% more than the world index, closely followed by our growth manager at T. Rowe Price. Only the value-orientated Artemis fund struggled in the month. On an aggregated basis, the blend generated alpha in Feb and is now approaching 1% above the benchmark year to date. A similar pattern is applied across the board of our regional blend funds.

Two underperforming funds are worth noting. The first is Odey European, which maintains an elevated cash position in the rising market. We are reviewing this position on two fronts, one being the opportunity cost of holding this strategy going forward and the second whether the cash holding can be justified as a successful tool by the manager. The second fund is Majedie UK, which struggles to keep pace with the FTSE 100. However, we are willing to accept this short term volatility since our conviction in Majedie still holds.

February was a quiet month in terms of trading activity. Rather than targeting any single region, we spent time rebalancing the entire portfolio on a line-by-line basis to ensure that the relative exposures and biases were correctly adjusted. As result of the rebalance, we topped up active exposure in European funds, as well as marginally increasing value title in Japan, the US and Asia region. In addition, two new funds, Jupiter European and Fidelity Asian small cap, have been added to the portfolio. We are also re-considering our US fund manager palette after strong performances this year. Our exposure to the US is currently passive because of the high efficiency of the market and the inability of managers to consistently add alpha in any time horizon less than 5 years. However, the evidence from our palette of pre-approved funds suggests they have been doing very well, so we are reconsidering our position to make sure we do not miss a good opportunity. Understanding whether this performance is sustainable is crucial to our decision if we were to redeploy capital in these prepared strategies. Finally, we have largely completed the work on two value-disciplined approaches in Europe. Our current exposure is biased marginally towards the quality and growth side of the spectrum, so adding one or both of these funds can redress the balance back to an aggregate core approach. One strategy is pure value and highly correlated to that style, so we expect it to be more volatile but the manager has a proven track record for risk managing this type of approach so that he is ready for when his style is in favour. The alternative is a younger, flexible strategy that is not as extreme in its positioning. It has an income producing bias that ensures it remains exposed to value but this is a by-product of its business-cycle investing philosophy.

Equities

<u>US</u>

US equity indices were up in February with the S&P500, Dow Jones Industrial Average, NASDAQ and Russell 2000 up +3.72%, +4.77%, +3.75%, 1.83% respectively. The strong performance came on the back of market sentiment buoyed by president Trump's "phenomenal" tax-cut promises and on the expectation of a softer regulatory environment, which could potentially provide a boost to economic growth and corporate profits. As a result of the continued strength in the economy, the probability of a rate hike at the next Federal Reserve ("Fed") meeting on the 15^{th} of March has risen considerably to 98%. On the macro economic front, US retail sales rose +0.4% pointing at strong domestic demand. The US consumer price index also rose by 0.6% versus expectations of a 0.3% increase over the month as revealed by the Bureau of Labor Statistics. The Philadelphia Fed manufacturing index surged to 43.3 from 23.6 in January beating expectations for a decline to 18.0. Finally the consumer sentiment index printed at 114.8 in February versus 111.6 last month, beating expectations for a decline to 110.9 and the Chicago Purchasing Manager's Index rose to 57.4 from 50.3 in January beating expectations for a reading of 53.0.

<u>UK</u>

UK equities were up on the month with the FTSE100 index delivering +2.31%. This was on the back of strong investor sentiment regarding the global economy and despite disappointing UK economic data. UK inflation data, released this month for the month of January disappointed as the consumer price index came in at 1.8% below the expected 1.9%. Manufacturing numbers for the month of January were also slightly down coming in at 55.9 from 56.1 the previous month. The services PMI fell to 54.5 versus an expected 55.8 print. The unemployment rate in the three months to December was revealed to have been unchanged from the previous quarter at 4.8%.

<u>Europe</u>

The MSCI Europe ex UK returned 2.6% in February in Local terms. However, headlines concerning the French election led markets to flee to safe assets again. Defensive sectors such as staples and health care outperformed cyclical sectors such as consumer discretionary and financials. The spread on the yield between French bonds and German bunds spiked to levels not seen since 2012.

The Europe economy continues pointing to robust growth over the course of the month, despite being overshadowed by political risk. The Euro area flash Composite PMI rose to 56 in February, hitting a 70 month high. This increase was primarily driven by a strong Services reading, however Manufacturing PMI also recorded the highest reading since April 2011. On an individual country basis, both Germany and France saw strong flash prints in February. Eurozone consumer prices rose sharply to 1.8% year on year in January, while core inflation was unchanged for the month. The divergence between headline and core inflation was driven primarily by energy prices. The labour market was improving, with Euro area unemployment rate remaining stable in January at the lowest level since May 2009.

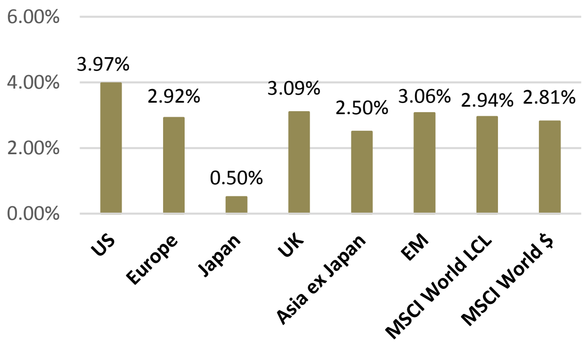
<u>Japan</u>

In Feb, the MSCI Japan NR Index advanced 0.50% in local currency terms while Yen was range trading between 112 and 114. The Japanese market soared on a weaker yen towards the end of month as expectation of March rate hike rose.

Japan's economy continues to show signs of a recovery. The February Reuters Tankan manufacturers DI print was strong at +20, the sixth consecutive month of improvement. Non-Manufacturing Diffusion Index worsened by 4 points to +26 in February, after improving 11 points in the previous month. Core inflation excluding volatile food prices rose 0.1 percent, mainly due to an uptick in energy prices, posting the first increase since Dec 2015. Nominal cash wages in Japan rose 0.1% year-on-year in December, while basic wages rose 0.5%, continuing on the stable positive trend since July 2016. The unemployment rate edged slightly lower to 3% and the number of jobs per applicant remained at a 26 year high. Household spending slumped in January however, even as the job market tightened further, underscoring the fragile nature of Japan's economic recovery.

In this backdrop, the Bank of Japan ("BoJ") increased growth expectations for the next two years. For the fiscal year 2017, it raised its economic growth forecast to 1.5% from 1.3% and for the fiscal year 2018, it raised its forecast to 1.1% from 0.9%. Following this the BoJ left policy unchanged, affirming its stance on a targeted yield levels.

Chart 4: February 2017 Equity Performance



Source: Bloomberg

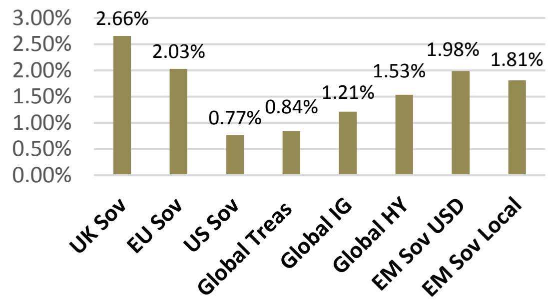
Fixed Income

February was a distinctly meritorious month for fixed income with major asset classes posting healthy gains across the board. Global treasury bonds gained +0.8%, global securitised bonds +0.5%, global investment grade corporate bonds +1.2% and emerging market sovereign bonds +2.0%, leaving the broad market Bloomberg Barclays Global Agg Hedged USD Index +0.9% for the month.

The underlying market drivers to these returns centred around a further improvement in global macroeconomic indicators, specifically in the US, Europe and Emerging Markets and a halt to the upward march of inflation expectations, which have been broadly on the rise since July. This combination of improving economic fundamentals (for credit markets) and stickiness of inflation expectations around key central bank targets (for rate markets) was the fillip needed to re-energise investor appetite and fixed income assets in 2017. Spreads were a notable beneficiary of these developments as global investment grade and global high yield spreads over equivalent government bonds declined to 119 and 381 basis points respectively, with global high yield bonds closing at their lowest levels since the summer of 2014.

There was no portfolio activity during the month other than a periodic rebalance of securities back to their target weights to address a cumulative build-up of market drift in certain areas of the portfolio. We remain positioned overweight credit sectors and underweight sovereign bonds relative to the benchmark.

Chart 5: February 2017 Fixed Income Returns



Source: Bloomberg

Currency and Commodities

The Bloomberg Commodity Total Return index ended the month at 177.55 up +0.21%. The sector movement within the month was muted once again. Softs gave back some of January's gains, 101.69 (-4.69% month on month). Energy 74.94 (-2.72% month on month). While WTI trades between 53 and 55, it was Natural Gas that continued its decline to close down -11.87% (0.83). The continued caution in the Gas market mentioned in the previous commentaries continues to play out with the Trump based tax uncertainty, along with no clarity on how policy will affect the largest gas exporter in the US market, Mexico. To counter the weakness, there was strength in both Metals Sub-Indices. The momentum fueled binge on industrial commodities continued with the Industrial Metals Sub Index at 240.17 (+2.24% month on month). Precious Metals also had a good month closing at 353.68 (+3.93% month on month). Silver was a star performer ending the month at 385.12 (+4.92% month on month).

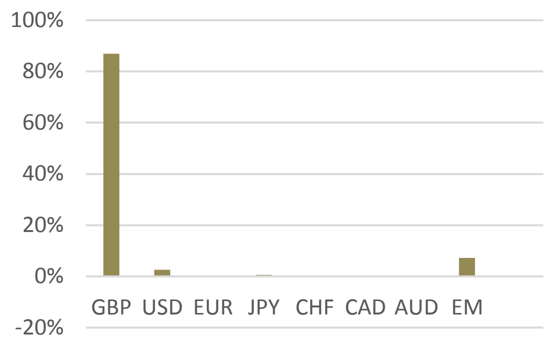
GBP/ USD

GBP started the month strong at 1.2650 and subsequently drifted lower to close the month at 1.2380. The ramifications around Brexit and the political noise around the process continued to drive moves in the currency pair. There seemed to be no upward catalyst for the pair when Bank of England ("BoE") Governor, Mark Carney testified before a parliamentary committee about the inflation report: Despite stronger inflation and decent economic numbers, the BoE is reluctant to raise rates, as it continues to maintain a neutral monetary policy stance.

EUR/USD

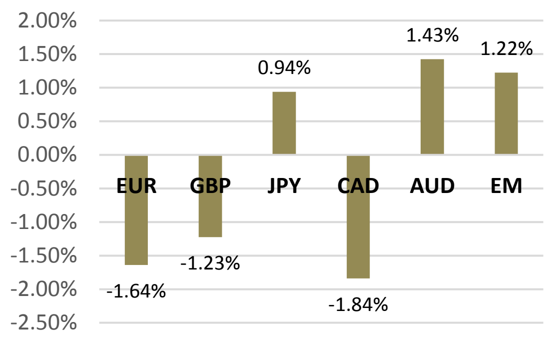
The EUR endured a similar fate to GBP starting the month strongly against the dollar (reaching highs of 1.0784) however fizzling to close at its intra month low of 1.0576. Top-tier European data was strong. The economy grew by 0.5% in Q4 2016, the unemployment rate surprisingly fell to 9.6% and the inflation rate beat expectations, inflation reaching 2% in the latest Eurozone reading. However, the strong data was subdued by US rate hike probabilities for March climbing to 80%, leading to dollar strength. The continued political uncertainty in the Eurozone will be the key driver of moves in this cross.

Chart 6: February 2017 Currency Allocation



Source: Bloomberg

Chart 7: February 2017 Currency Performance vs USD



Source: Signia Wealth