IMPERIUM CAPITAL

momentum

NEWPORT

Weekly Digest

Week ending **16 July 2017**

STIR crazy

Only a few week ago the UK was still reeling from the shock result of the general election and it would be another fortnight before Theresa May and the DUP finally hammered out a deal. All the while markets in the UK remained relatively contained against the already uncertain backdrop of the government's forthcoming Brexit negotiations. Barely had the ink dried on the DUP agreement when the European Central Bank Forum kicked off in Sintra, Portugal, and Mario Draghi, President of the ECB, unwittingly set the cat amongst the pigeons when he said that "deflationary forces have been replaced by reflationary ones". This caused alarm when investors interpreted his positive tone as a precursor to the central bank slowing its economic stimulus package more quickly than markets were discounting. ECB officials were quick to voice concern that the comments had been misjudged but this didn't stop sharp price action in rate and FX markets.

Short term interest rates (STIR) have always been sensitive to news flow but in recent years words have spoken louder than actions with traders poring over the minutes of central bank meetings looking for shifts in the language that provide some clues to the direction of future rate policy. Incredibly, it is already nearly five years since Super Mario's "whatever it takes" speech where his very deliberate use of language brought some closure to that dark episode of the crisis. On that occasion markets heard what they wanted to hear and peripheral bond yields fell; in Sintra his words caused bond yields to spike, and not just in Europe but across the globe. His comments helped to push gilt yields sharply higher, arguably having greater impact than the increased-if-still-distant threat of a hard left labour government. The yield on two year gilts surged in June from as low as 0.09% around the time of the election to 0.36% at the end of the month, rising above the Bank of England base rate of 0.25% and spurred on by hawkish comments from the Bank of England's Chief Economist.

Bond yields are, at their simplest, derived from investor expectations of where successive short term rates markets should price, with an additional 'term premium' for the increased uncertainty that comes with projecting longer term interest rates. This is why the 'normal' shape of the forward interest rate market tends to be upward sloping, compensating investors for that uncertainty (or more precisely the risk of higher future inflation). Although still very flat, over the last month there has been a marked move higher in STIR markets such that the probability of the Bank of England raising interest rates back up to 0.5% before the end of the year has risen from the low single digits to around 50% today. Indeed some commentators would say we never needed the post Brexit base rate cut with the economy faring reasonably well in the 12 months since. On Tuesday (18 July) we receive the latest UK inflation numbers and whilst these have been moving sharply higher in recent months, squeezing real wages into negative territory, these should be expected to moderate and fall through the second half of the year as the effect of Sterling's devaluation rolls out of the year on year numbers.

A hike before year end looks premature. Whether that plays out or not, it doesn't change the portfolio manager's view that gilts remain expensive, with next to no term premium. They don't pretend to have an edge in forecasting short term rates, nor necessarily do they try to; it is hard to have a competitive advantage against the thousands of dedicated traders and algorithms operating 24/7 solely in rates markets. What is more important to the manager's is the longer term real opportunity, and that remains poor. As we've seen over the last month even the most meticulously scripted words can be interpreted the wrong way, and crazy as this world is, that will only stir up trouble for the rest of us.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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The **Marketplace**

- Oil prices rose 4.7% on the week with Brent standing at USD49 a barrel
- Gold rose 1.4% to 1228.5
- MSCI All-Country World Index set an all-time high for the week closing at 473.78
- More evidence of strength in the global jobs market

Market **Focus**

US

- Yellen Testimony seen as balanced and gradualist - addressing low inflation (<2% target) reducing the balance sheet and allowing for interest rate rises over the longer term
- The S&P 500 Index set a record high finishing the week at 2,459
- The Dow Jones also finished at record high of 21,638
- Nasdaq was up +3.2%
- US CPI missed expectations for a 4th time on Friday
- PPI reporting was mixed: +0.1% month-on-month for June beating expectations though annual rate fell to +2% from 2.4% yoy
- JPM and Citigroup posted better than expected earnings with JPM posting the highest ever annual profits for a bank

UK

- Bank of England Deputy Governor indicated he'd vote against higher interest rates in next month's MPC meeting, prompting a 0.2% fall in sterling
- The Great Repeal Bill unveiled, aiming to incorporate 12,000 EU laws into British law –a cornerstone of the Brexit project
- Inflation is above target at 2.9% (vs 2%) on the back of weak sterling but growth struggling amid Brexit uncertainty.
- UK Equities up 0.4% with the FTSE closing at 7394.8
- Slowest 3 month average weekly earnings in 2 ½ years but ILO unemployment rate at 4.5% - the lowest since 1975

Europe

- Strong earnings statement around jobs, Europe amongst strongest global performers in Q2
- Inflation decelerated further in June (HICP rate 1.3% year-on-year) though stronger in services. Perceptions remain that ECB stimulus removal will be slow, with nothing expected to happen until 2019
- Treasury-bund spread narrows as euro area surprises overtake US
- European stocks had their biggest two day gain in three months making it the strongest week in two months
- Euro Stoxx 600 closed the week at 386.7, up 1.8%

Asia

- Nikkei closes +1% on the week
- Hang Seng closes the week down +4.1%
- South Korea's Kospi index set a record high closing on Friday at 2,425
- China delivered strong figures: GDP expanded 6.9% in Q2, with industrial output up 7.6% in six months and retail sales up 11% over the last year

Alex Harvey (CFA) & James Jones

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 July 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	1.4%	1.5%	10.7%	15.3%
United Kingdom	GBP	0.4%	1.0%	5.7%	15.2%
Continental Europe	EUR	1.8%	2.2%	11.1%	20.4%
Japan	JPY	1.1%	0.8%	8.3%	26.7%
Asia Pacific (ex Japan)	USD	3.7%	2.9%	23.3%	23.7%
Australia	AUD	1.1%	0.8%	4.0%	11.2%
Global	USD	1.8%	1.7%	12.5%	16.6%
Emerging Market Equities					
Emerging Europe	USD	5.0%	4.6%	8.6%	18.2%
Emerging Asia	USD	3.9%	3.3%	27.2%	27.4%
Emerging Latin America	USD	6.8%	6.8%	17.6%	17.3%
BRICs	USD	5.2%	5.1%	22.8%	26.3%
MENA countries	USD	2.4%	1.0%	5.2%	11.9%
South Africa	USD	7.7%	4.8%	13.3%	10.7%
India	USD	3.0%	4.6%	28.9%	21.6%
Global emerging markets	USD	4.6%	3.9%	23.1%	23.7%
Bonds					
US Treasuries	USD	0.4%	-0.1%	1.9%	-2.5%
US Treasuries (inflation protected)	USD	0.6%	0.0%	0.9%	-1.2%
US Corporate (investment grade)	USD	0.6%	0.2%	4.0%	1.4%
US High Yield	USD	0.5%	0.3%	5.2%	10.0%
UK Gilts	GBP	0.1%	-0.6%	-0.4%	-2.7%
UK Corporate (investment grade)	GBP	0.1%	-0.3%	2.2%	2.9%
Euro Government Bonds	EUR	0.4%	-0.5%	-1.4%	-3.9%
Euro Corporate (investment grade)	EUR	0.3%	0.2%	0.9%	0.4%
Euro High Yield	EUR	0.3%	0.1%	4.3%	8.1%
Japanese Government	JPY	0.2%	-0.1%	-0.5%	-4.3%
Australian Government	AUD	0.1%	-0.2%	2.2%	-1.5%
Global Government Bonds	USD	0.9%	-0.1%	4.0%	-4.0%
Global Bonds	USD	0.8%	0.1%	4.4%	-1.7%
Global Convertible Bonds	USD	1.6%	1.0%	8.0%	7.6%
Emerging Market Bonds	USD	1.3%	0.2%	6.5%	2.3%

Source: Bloomberg

Asset Class/Region	Currency	Currency returns			
		Week ending 14 July 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	1.3%	-0.1%	1.9%	-4.7%
Australian Property Securities	AUD	-0.7%	-1.3%	-7.3%	-15.3%
Asia Property Securities	USD	2.6%	1.2%	17.1%	13.2%
Global Property Securities	USD	1.9%	0.6%	8.6%	2.5%
Currencies					
Euro	USD	0.4%	0.4%	8.9%	3.1%
UK Pound Sterling	USD	1.5%	0.6%	5.9%	-2.0%
Japanese Yen	USD	1.3%	-0.2%	3.9%	-6.4%
Australian Dollar	USD	2.7%	1.7%	8.5%	2.4%
South African Rand	USD	2.7%	0.1%	5.0%	9.1%
Swiss Franc	USD	-0.1%	-0.6%	5.6%	1.7%
Chinese Yuan	USD	0.5%	0.0%	2.8%	-1.2%
Commodities & Alternatives					
Commodities	USD	1.7%	0.1%	-5.7%	-2.8%
Agricultural Commodities	USD	-1.4%	0.1%	1.5%	-2.0%
Oil	USD	4.7%	2.1%	-13.9%	3.3%
Gold	USD	1.4%	-1.1%	6.6%	-8.0%
Hedge funds	USD	0.5%	0.5%	3.1%	5.5%

Source: Bloomberg

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