DART CAPITAL

Investment Brief - January 2017

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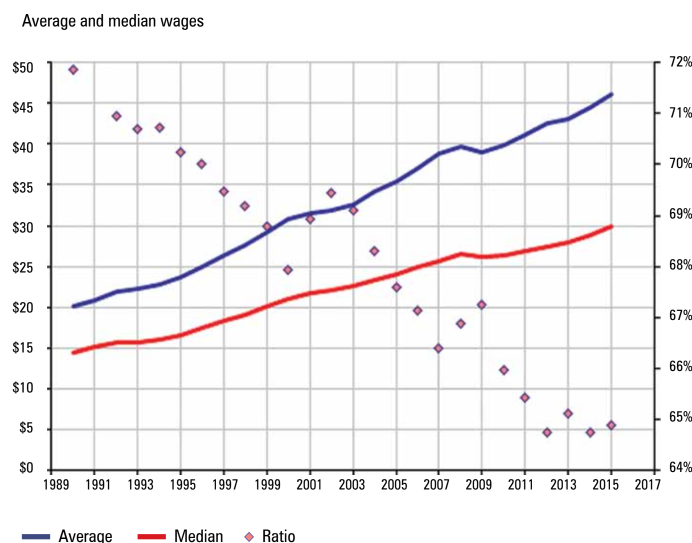
Last year saw a shift in the mind-set of policymakers in developed markets, with a growing emphasis on fiscal stimulus measures and a move away from the dependence on unconventional monetary policy. As we look ahead to 2017, we retain a broadly neutral allocation to equities and an underweight exposure to the fixed income asset class.

We see the growth of populist politics in developed economies, most recently highlighted by the victory of Donald Trump in November's US election, as an understandable reaction to the growth in income inequality and the stagnation of median incomes which has occurred since the onset of the financial crisis. The chart below illustrates this growing income inequality within the US economy. While markets reacted positively to Trump's victory and shunned safe-haven assets, we would note that the prospect of increasingly profligate governments could well eventually prove to be positive for the price for true hard currencies, such as gold, which offer an alternative store of value.



Median income is the amount that divides the income distribution into two equal groups, half having income above that amount, and half having income below. The average income is the amount of total income earnt by workers divided by the number of workers within the workforce. The decline in the ratio of median worker income to average worker income indicates growing income inequality between lower and higher paid workers.

Source: Social Security Administration

Client portfolios were well protected from the back-up in yields which occurred within the bond market over the fourth quarter as the majority of exposure to the asset class remains in short-dated, less interest rate sensitive bonds. With regards to the UK specifically, while the Governor of the Bank of England, Mark Carney, has spoken loosely about the potential for the base rate to be raised this year we don't expect this to materialise as we anticipate that real wage growth, and subsequently the economy, will slow due to higher food and energy costs. From here, while we do continue to see the valuation on high quality long-dated bonds as moderately expensive with investors not being sufficiently compensated for the risk of future inflation, we are cognisant that the structural forces which have driven bond yields lower over recent years remain largely in place. In particular, developed economies continue to grapple with a combination of ageing populations, high household and government debt levels and reduced labour bargaining power (due to both burgeoning Emerging Market labour forces and technological advances) - all of which could serve to inhibit economic growth even in the face of higher fiscal spending by governments.

Whilst we retain a broadly neutral overall exposure to equities based on valuations which are reasonable but certainly not cheap, we have been keen to ensure that portfolios are well balanced between quality stocks, which are well insulated should there be an economic downturn but remain expensive, and cheaper, more cyclical stocks which offer a greater degree of inflation protection. This focus on factor exposure is perhaps best highlighted by our fund selection within European equities, where we introduced a holding in a more value-biased fund in mid-2015 in order to take advantage of the attractive valuations in cyclical sectors where many stocks were trading at well below book value. This positioning helped portfolios benefit from the rotation from growth to value stocks which occurred over the fourth quarter.

From a geographical perspective, while US equities are set to benefit from the pro-growth policies of President-elect Trump (most notably greater infrastructure spending and reduced household and corporate tax rates), this positive is likely to be tempered by a faster pace of interest rate rises by the US Federal Reserve. Higher US rates could put pressure on valuations which are well above historic averages. Whilst certainly a higher risk market due to the continued overhanging spectre of deflation, Japanese equities are well positioned to benefit from a stronger US economy through a weaker Yen and higher exports to the world's largest economy. Furthermore, with Japanese corporates sitting on very large cash balances and placing a greater emphasis on shareholder returns, we believe the market remains an important component of clients' international equity allocations. Although economic growth levels did stabilise in China over 2016, bolstered by the government's fiscal stimulus package, we prefer other Emerging Markets, such as India, where debt levels are far lower and the growth of the domestic middle class is still in its infancy.

Following the dislocation which occurred within the UK commercial property market post-Brexit, capital values have largely recovered as overseas buyers have stepped up their purchases aided by the dramatic weakening of the Pound in the aftermath of the vote. Our favoured funds within the asset class have little exposure to central London, instead favouring other so-called "Big 6" cities and regional towns in southern England where the lack of new building developments in prime locations since the financial crisis looks set to support rent levels.

We continue to retain significant exposure to non-directional long/short equity funds which, due to their either zero or very low net exposure to the equity market, are positioned to deliver uncorrelated returns to that of global markets. Notably, within this space we look to blend fund managers with differing styles which are likely to deliver strong performance at different points in the cycle.

As we enter 2017, we continue to favour equities over bonds although we are broadly neutral on equities overall in light of corporate profit growth which has remained weak and valuations which are reasonable but by no means cheap. Significant holdings in non-directional absolute return funds and short dated bonds provide us with firepower should there be a dislocation within risk assets.

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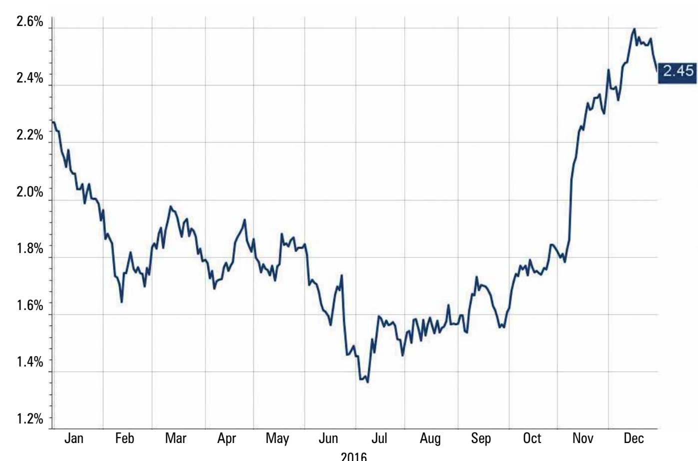
The quarter was dominated by the US election with markets reacting dramatically to the election of Donald Trump as President and initial concerns were replaced with risk-on sentiment as investors continued to rotate out of fixed-income and other safe havens into cyclically exposed assets.

Since the oil price started its retreat from its level of over $100 per barrel in mid-2014, the fall in commodity prices has been one of the driving factors behind declining, and often negative, inflation within developed economies. However, this effect is starting to reverse with the oil price, having fallen as low as $25 per barrel in January of this year, rising from $49 to $55 over the period having been further bolstered by November's OPEC agreement to reduce output by c.1.3m barrels per day. This "base effect" has already started to push inflation higher and was, along with the US election result, instrumental in driving bond yields higher over the quarter with the yield on the 10-year US Treasury rising from 1.6% to 2.45% over the period as shown in the chart below.



US 10 Year Treasury Yield
Source: Thomson Reuters Datastream

As outlined in our updates prior to the vote, we believed that Donald Trump and the Republican party could well cause an upset in the US election on the basis that much of Trump's campaign rhetoric clearly struck a chord with working class voters, many of whom feel disenfranchised following years of growing income inequality. The market reaction to Trump's victory was dramatic, with safe haven assets, particularly the Yen and gold, initially rallying before selling off sharply as investors priced in the inflationary impact of Trump's growth friendly policies and de-emphasised his more aggressive rhetoric regarding immigration controls and trade restrictions. In particular, the President-elect's plan to spend over $1trn on improving the country's ailing infrastructure, as well as cut household and corporate tax rates, helped boost the domestic equity market with the S&P 500 gaining 3.3% over the quarter in Dollar terms. Furthermore, there was a marked divergence in sector performance with MSCI USA Cyclical sectors gaining 5.3% while the equivalent Defensive Sectors index was down 1%.

Bolstered by the market's positive reaction to the election result and third quarter GDP figures, which showed the economy grew at an annualised pace of 2.9% over the third quarter, the Federal Reserve raised the Federal Funds rate by 25 basis points to 0.5%-0.75% in their December meeting while they also increased their forecast for the expected number of rate rises in 2017 from 2 to 3. The prospect of higher US interest rates and stronger growth drove the gold price down 12.5% over the period ending the quarter at $1,151 per oz.

The UK economy grew by 0.6% quarter-on-quarter (q-o-q) over the third quarter, a strong showing given the ongoing uncertainties emanating from the EU Referendum result. Although it has tempered slightly over recent months, the weakening of sterling which has occurred since the referendum result looks increasingly likely to push inflation, which as of November stood at 1.2% based on the Bank of England's preferred CPI metric, to well above the Bank of England's 2% target in the second half of 2017 as the price of imported goods, particularly food and energy, accelerates. On a more positive note, whilst weaker sterling will push inflation upwards, survey data has indicated that the weaker currency has already started to benefit the manufacturing sector through higher export demand. Although lawmakers did, in a December ruling, back the Conservative government's timetable to trigger Article 50 by the end of March, there remains much uncertainty over the relationship the UK will have with the EU once the exit process is completed. Most of the uncertainty is centred on whether UK companies will retain access to the single market, with this expected to hinder business investment over coming quarters. Led largely by the movements in US yields, the yield on long-dated Gilts rose markedly over the period with the iBoxx Sterling All Maturities index losing 4.4% in capital terms. MSCI United Kingdom All-Cap gained 3.1%.

Japanese equities were the largest beneficiary of the risk-on sentiment which dominated following the US election, with lowly valued cyclical stocks delivering strong gains aided by the rise in global inflation expectations and the weakening of the Yen against the Dollar. Japanese GDP grew at an annualised pace of 1.3% in the third quarter, boosted by a rebound in exports although household consumption and corporate capital investment remained weak. The country's unemployment rate rose slightly to 3.1% in November although our fund managers on the ground in Japan believe that this figure is understated due to many large Japanese corporates still harbouring a large number of "internally unemployed" workers who they no longer require but are unable to lay-off due to the country's lifetime employment culture. MSCI Japan gained 14.9% over the period in Yen terms.

The Eurozone economy grew at grew 0.3% q-o-q in the third quarter, in line with previous estimates, while survey data indicated that the growth for the current quarter could accelerate slightly aided by an improvement in global demand for German goods. December included the Italian Referendum on constitutional reform which saw the No vote winning by a considerable margin. As he had been a major backer of the Yes campaign, Prime Minister Renzi, resigned immediately following the announcement of the result and new elections are set to be held in 2017. Later in the month, the European Central Bank (ECB) announced plans to reduce their asset purchase program from €80bn to €60bn per month from April. Although the consumer price inflation (CPI) index for the currency bloc stood at only 0.6% in November, inflation is expected to move closer to the ECB's 2% target over the coming year due to the base effect from higher oil prices. MSCI Europe ex-UK gained 5.8% in local currency terms over the period.

Having delivered strong returns since hitting their lows in January, Emerging Market assets came under pressure following Trump's election victory as rising US yields and the prospect of reduced global trade caused investors to re-assess their positions. In a related move, the Chinese authorities took steps to again weaken the Renmimbi's peg against the US Dollar as continued capital outflows and the stronger US Dollar combined to pressure the currency. In spite of this, the wider Chinese economy continues to muddle through, aided by government stimulus particularly within areas such as infrastructure. The election result directly impacted Mexico, which looks set to suffer from reduced trade with the US as Trump looks to crack down on what he sees as the excessive outsourcing of US jobs to their southern neighbour, and the Peso fell 6.9% against the Dollar over the period. In a surprise move, the Indian government announced mid-quarter that with immediate effect the widely used 500 and 1000 Rupee notes – which account for over 85% of the economy's currency in circulation - would be taken out of circulation, a move which caused an immediate slowdown in the country's level of economic activity. The aim of the move was to reduce the size of the country's black economy and increase the tax generated by the government and, in spite of short term pain, is seen by many investors as having positive long-term implications for the economy and domestic equity market as more resources are diverted away from the black economy. MSCI Emerging Markets lost 4.6% in US Dollar terms over the period.

It was another eventful quarter for global markets, with investors growing used to the changing political landscape which increasingly favours expansionary fiscal policy over budgetary prudence. While markets moved to a risk-on position over the final months of 2016, we remain wary that equity markets could well suffer a pullback should investor faith in politicians and central bankers start to wane.

Data sourced from FE Analytics and Thomson Reuters Eikon.

Fund Spotlight - Jupiter UK Special Situations

Launch Date:	19/09/2011
Fund Size:	£1,520 Million
Asset Class:	UK Equities
Manager:	Ben Whitmore – Graduate of Cambridge University, previously worked at Schroders (1994 – 2006)

Value investing has been shown to deliver strong returns to investors over the longer-term, although few investors can tolerate the long periods of underperformance the style can experience. In particular, when expectations for inflation and economic growth are low and falling, the value style tends to underperform with investors preferring higher quality stocks with more stable levels of profitability during these periods. As shown below, this has largely been the case over recent years although this trend started to reverse at the start of last year with value starting to outperform.

A - MSCI United Kingdom Growth TR in GB (0.00%)

B - MSCI United Kingdom Value TR in GB (-9.93%)

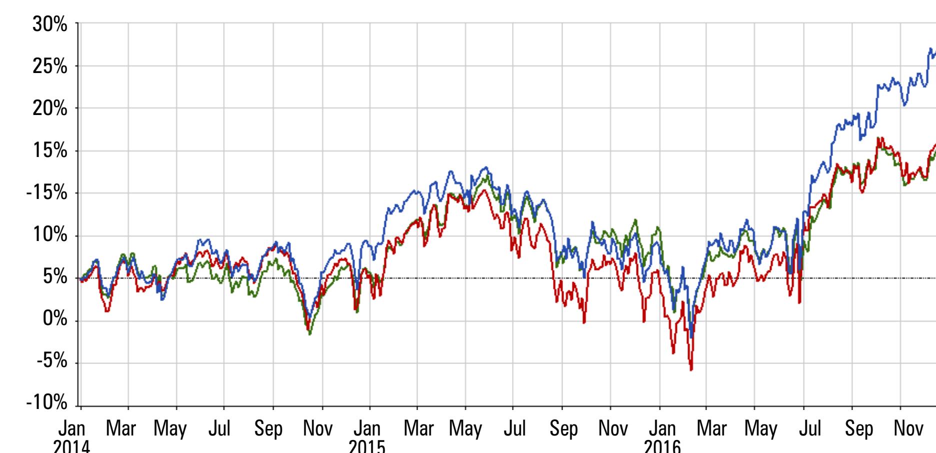
31/12/2012 - 30/12/2016 Data from FE 2017

The Jupiter UK Special Situations fund has been on the Buy List since 2011 and is now held across Risk Strategy 3-5 portfolios. The manager of the fund, Ben Whitmore, is a highly regarded value investor and has built a strong long-term track record by selectively investing in out of favour, lowly valued large and mid-cap stocks. Prior to moving to Jupiter in 2006 and taking over the management of the Special Situations fund, Ben was responsible for managing several mandates at Schroders totalling c.£2bn in assets, including the well-known Recovery fund. At Jupiter, Ben heads up the UK Value team and is lead manager on both the UK Special Situations fund and the Income fund with these funds totalling c.£3.6bn in assets.

The fund manager's process is centred around the idea that accurately forecasting earnings for a company several years into the future is close to impossible with empirical evidence showing that sell-side analysts are, on average, very poor at estimating a company's future level of profits. For this reason, when looking for new stocks to buy, Ben places little emphasis on valuation metrics which are based on a company's current and future levels of profitability, such as the widely used P/E ratio, as companies which look cheap on these metrics may be experiencing peak levels of profitability which they will be unable to maintain into the future. Instead, the manager favours metrics which assess the market value of the company's equity with its long-term historical ability to generate profits. Foremost among these is Ben's favoured metric for finding cheap stocks, the Shiller price to earnings ratio, which compares a company's current share price with the average inflation adjusted earnings per share that the business has generated over the past 10 years.

Importantly, companies which look cheap on this metric are likely to be suffering from weak profitability and the next stage of the process involves a rigorous assessment of the company's franchise in order to determine whether the business is merely suffering due to cyclical factors or is in fact in structural decline. A core differentiating factor for this fund compared to many of its peers is that the manager will invest in companies with weakened balance sheets as long as he believes that the company will have a reasonable quality balance sheet at the mid-point in the cycle. This approach led the manager to invest in high-risk mining stocks such as Anglo American and South 32 at close to their share price lows at the beginning of this year, and subsequently benefit as the prices of these shares recovered.

The fund is currently heavily tilted towards the consumer services and financials sectors. Within consumer services, one of the fund's largest holdings is Smiths Group, which own the WH Smiths stores. The market expectations for Smiths Group are currently very low due to concerns over competition from online retail which Ben believes are overdone given the company's dominant position in locations with consistently high footfall, particularly train stations and airports. Exposure to financials is concentrated in banks HSBC, Standard Chartered and Royal Bank of Scotland, as well as the insurer Aviva. Each of these businesses are trading at close to or below their net asset value and would likely see their share prices perform strongly should bond yields continue to rise.



A - Jupiter - UK Special Situations I Inc TR in GB** (27.18%)

B - MSCI United Kingdom All Cap TR in GB (17.96%)

C - IA UK All Companies TR in GB (16.96%)

31/12/2013 - 30/12/2016 Data from FE 2017

**The history of this unit/share class has been extended, at FE's discretion, to give a sense of a longer track record of the fund as a whole.

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