*For professional investors only - Not for onward distribution

ARIA CAPITAL MANAGEMENT

ATP QUARTERLY: ALL TERRAIN PORTFOLIO STRATEGY

JULY 2017 FANGS LOSE THEIR BITE

MATT BRITTAIN
PORTFOLIO MANAGER

ASSET ALLOCATION HIGHLIGHTS:

» The rise in global bond yields has been largely reflective of stronger global growth rather than becoming restrictive. We remain strategically overweight equity strategies, but tactically we have raised cash within them.

» The Fed has more scope to raise rates than the ECB. Not only is labour market slack much higher in the euro area, but the neutral rate is considerably lower there too.

» Financial conditions have eased a lot more in the U.S. than in the euro area, which should support relative U.S. growth in the months ahead.

» U.S. inflation should see a pick up second half of 2017, removing a key obstacle to further Fed rate hikes.

» Calibrating monetary policy and timing interest rates is very difficult given the lead time before they take effect in the real economy.

» The sell-off in the US Dollar looks to be overdone, we expect it will resume its strength against emerging market and developed market currencies.

» A rally in oil over the coming months as global inventories decline, and banking profits improving with higher yields, should mean the FTSE 100 finds support circa 7100 on the next move down.

FROM BUST TO BOON:

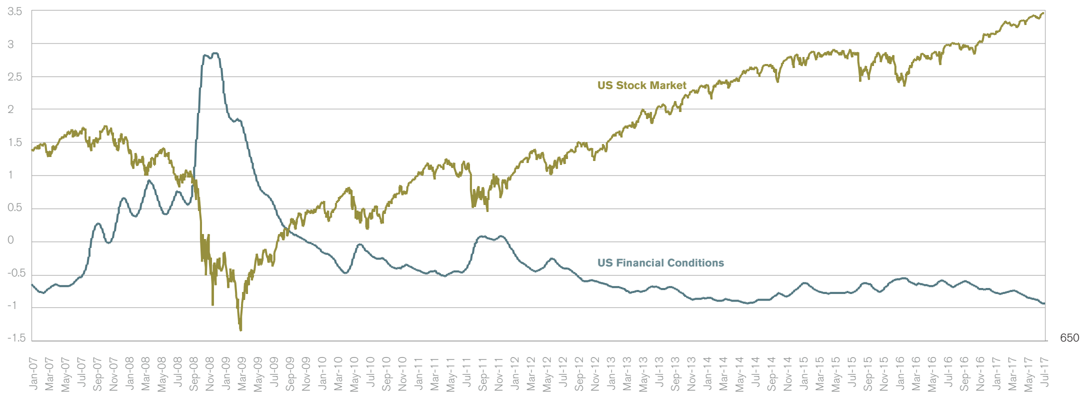
Global growth estimates have been trending higher over the past 12 months, having bottomed last summer. We had long maintained that earnings could bottom in the 3rd quarter of 2016, which seems to have been proven correct. In fact, the general earnings rebound globally we believe is underappreciated. Whilst the oil collapse caused investor consternation and market volatility, it also seems to be the ultimate catalyst for an improvement in global growth.

We're firmly of the view that we are living through a paradigmatic change in energy markets. The marginal cost of production is now circa 48 US Dollars led by the US shale gas producers. OPEC has been dethroned and the geo-political clout of the oil exporting nations has dwindled. Initially, this precipitous drop in energy capital expenditures meant a global slump in trade. However, this was the beginning of a global reallocation of resources which has led to a significant improvement in corporate profitability and productivity. It was the foundation stone of the bottoming in earnings late last year.

What has been a significant blow for economies such as Brazil and Russia, has been a major windfall for households globally, especially poorer ones who spend a disproportionate share of their income on energy and fuel. Industries that use oil as an input also benefitted as basic materials and industrials have been some of the strongest sectors. Simply put, the oil crash went from being a bane to a boon for the global economy.

In addition to plunging input prices, financial conditions in most countries have eased substantially since the start of the year thanks to rising equity prices, lower bond yields, and narrower credit spreads. Changes in monetary conditions, do take some time to transmit to the real economy – for lower or higher interest rates for example, there is typically a lag time of at least 12 months before the impact is felt. Whilst the US Federal Reserve has increased interest rates, generally credit conditions (i.e. the cost of borrowing has actually fallen), particularly as the general fall in commodity prices has tempered investors' inflation expectations. We should expect, (short of any significant geo-political event – Mr Trump cannot really be considered a Black Swan event anymore – but North Korea could), that global growth will at least hold up. This is set against a back drop of a poor recovery in global growth in recent years.

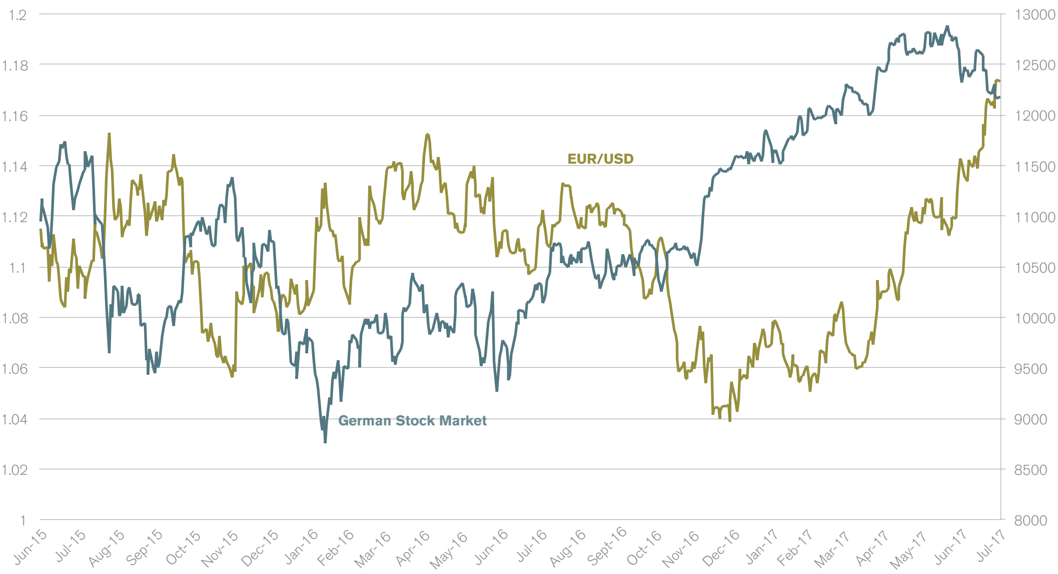
CHART 1: FINANCIAL CONDITIONS INDEX



Easing monetary conditions have supported equity markets

The euro area, with confidence buoyed slightly by Emile Macron's arrival in the Élysée Palace, and the IMF's continued benevolence towards Greece, splutters along. The purchasing manager indices (PMIs) dipped a bit in June, but remain at levels consistent with above-trend growth. Corporate balance sheets in the euro area are improving and credit growth is accelerating. Mario Draghi seemed to light a fire under global bond yields, driving billions of European debt into positive yields with his speech at Sintra recently. Whilst still dovish, investors interpreted his comments as those which might precede an end of his monetary stimulus programs in Europe, which also sent the Euro higher. A stronger Euro though has begun to hamper European stock markets' progress – particularly Germany and its heavily export driven economy, which has sped along in recent years driven by a faltering Euro.

CHART 2: EUR/USD AND DAX OVER LAST 6 MONTHS



Recent strength of the Euro has proved a headwind for European equities

EUROPE HAS ALWAYS BEEN THE TORIES' 'THIRD RAIL'....

Disappointingly, the U.K. is the only major country where growth has faltered this year. Worries over Britain's future relationship with the EU have likely contributed to the slowdown. Sterling has seen a rebound against the US Dollar – although a limited bounce that should be expected given the duration and extent of its' previous decline. Ongoing Brexit angst will keep the Bank of England on hold, which should contain any major rise in Sterling which of course makes the global companies listed in the FTSE 100 attractive.

It seemed shrewd at first: whilst the Remainers were defeated and Leavers authored their own destruction, Theresa May's strategy of saying nothing and projecting a steely competence seemed to be just the firm hand on the tiller that the UK needed. Nietzsche quipped 'he posits a principle, where he lacks a capacity'. It has been surprising to see how quickly an impression of unshowy competence has become a political personality that is cold, remote, automaton and with a demonstrable inability to reach an electorate. Mrs May should take responsibility for the collapse in her political standing and election campaign, but not the national mood, which was pre-destined to give the Tories a bloody nose regardless. Labour have had the luxury of sidestepping any blame for the current mess in Westminster – a privileged position they should continue to drive home hard. The current electoral climate in the UK remains one of blame – should economic conditions continue to deteriorate the Brexit induced anger will only grow and need to find a target. Whilst the Conservative party should sensibly rally around their leader and consolidate in order to support a tolerable terms of Brexit with the EU, there is a school of thought that suggests Brexit will continue to claim political casualties and maybe they would be better served putting forward a scapegoat who was very vocal for the Leave Campaign – someone who could play the role of panto villain. There is one outstanding candidate for such a role, isn't there Boris?

ASSET ALLOCATION OUTLOOK:

Asset Class	Holdings	
Developed Market Equities	Fidelity Global Dividend Henderson Absolute Return Henderson European Smaller Companies	Earnings expectations are holding up, having bottomed late last year. Surprisingly, the global earnings revision ratio moved into positive territory earlier this year for the first time in six years. Global monetary conditions generally remain favourable. Volatility, while low now at 10, is mean reverting and could well rise this autumn as US central bank begins monetary “normalisation” measures by reducing its balance sheet size.
Emerging Markets	Goldman Sachs Emerging Equities M&G Emerging Markets Bond	One important risk, which we do not foresee, would be a faster- than--expected pace of global monetary tightening. This could result in relative currency underperformance for global investors and companies having difficulty refinancing in this highly indebted space. We favour Korea, Taiwan, India, Thailand, and China – all beneficiaries of lower energy prices and a pick-up in global economic activity.
Global Government Bonds	Axa Sterling Index Linked Bond	Much of the decline in bond yields earlier in the year was due to falling inflation expectations. That in itself was largely driven by the decline in commodity prices. Inflation is really yet to rear its ugly head so we expect yields to remain range bound. Brexit has the potential to upset the UK Gilt applecart. The U.K. is the only major country where growth has faltered this year. Ongoing Brexit angst will keep the Bank of England on hold, justifying a neutral weighting on gilts as further falls in inflation could push inflation rates and gilt yields higher.
Credit/High Yield	New Capital Wealthy Nations Bond Fund	We expect credit to continue to outperform government bonds in a rate--normalizing environment. However, we prefer the yield available on high quality dividend equities. Credit spreads have hit new lows, and it’s difficult to argue there is ‘value’ in this asset class.
Currencies	Montlake Dunn DMA UCITS Fund	Momentum in currency markets can be a powerful force, but the US Dollar weakness is now overdone. Over a 12-month horizon, the greenback will strengthen, as the Fed raises rates when most other central banks stand pat. At this point, much of the good news benefiting EM currencies has been priced in.
Commodities		While oil has made an impressive comeback since the early-2016 lows, a continued supply glut, and modest global growth will probably keep energy range--bound with a slight upward bias in 2017. Energy related investments are attractive when oil trades towards the bottom of its range at 40 USD.

Asset Class	Holdings	
Gold		Bullion will struggle when facing a stronger dollar and rising bond yields. However, once the Fed starts cutting rates again, or it becomes clear 'normalisation' has run its course, we should see more sustained gains.

FANGS LOSE THEIR BITE

The US stock market has been remarkably resilient in the face of everything that Donald Trump has had to throw at it. Investors' biggest disappointment has been the Administrations' inability to enact tax reform or a major fiscal stimulus. Ultimately, we believe it is likely that the US economy will slip into a recession without major tax reform – perhaps the only silver bullet it has left, but that is not in our immediate future.

The S&P is expensive relative to historical valuation ranges at 21.3 times earnings on the cusp of the Federal Reserve beginning 'quantitative tightening', or a shrinking of its $4.5 trillion balance sheet this autumn. It may even be the Federal Reserve try to engineer a pause in financial markets generally by becoming more vocal about its intentions, in an attempt to temper animal spirits slightly. However, its high valuations were anchored by 7% revenue and 14% earnings growth in the first quarter. CFO's have been remarkably adept at encouraging analysts to lower their earnings expectations so that results do not disappoint when they are announced.

An interesting development in recent weeks has been the 'leadership' in markets rotating to value shares, financials for example, which trade at comparably modest price to book value metrics, compared to the tech heavy momentum growth stocks in Facebook, Amazon, Netflix, Google, the semi-conductors and internet shares. With Brent's post Vienna collapse, oil and gas majors (notably Chevron, Occidental) also offer compelling value. Given the FTSE 100's composition, as investors shift their attention towards energy and financial stocks, it should perform relatively well against its international peers should this shift be enduring.

Brokers and analysts have widely touted the European valuation discount compared to its US counterparts, although much of the potential outperformance seems to be in the past now. A crowded trade, the rose on European equity markets bloom has come off in recent weeks as the yields on European government bonds have finally gone into positive territory. Mario Draghi will find it difficult to remain ultra-accommodative in his policy stance, when the US Fed would appear to be changing gear.

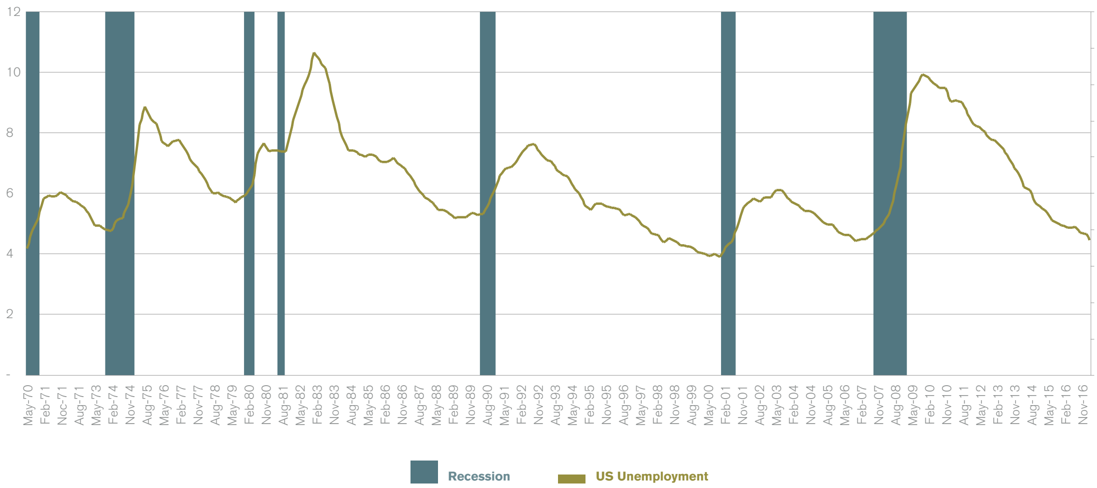
Japan remains relatively cheap given its stock market valuation at 16.3 times earnings while the Bank of Japan's zero yield policy should continue to keep the Yen weak. This is hugely bullish for Nikkei exporters, mainly Sony and Hitachi. After a 23% rally in 2017, the MSCI emerging markets index trades at 13 times earnings, at least 3 full points above its March 2011 bottom. If the US Dollar does find a firmer footing here, that could provide the catalyst for an overdue correction in emerging market equities and currencies.

ALL GOOD THINGS MUST COME TO AN END

There is a global recession in our future – that's not particularly enlightened on our part – there always is. Unfortunately, it will likely be one which is severe, and come at a time when central banks globally do not have much in their arsenal to counter. With interest rates at historic lows, there simply isn't room for significant monetary easing. Our current roadmap suggests economic deterioration begins in earnest next year although it seems as though central banks will do anything in their power to postpone the inevitable.

History shows that when an economy reaches full employment the odds of a recession grow. (see chart below). The U.S. unemployment rate now stands at 4.3% and is on track to break below its 2000 low of 3.8% next summer, if not before. Superficially unemployment does tend to trend in one direction or the other. I.e. once it turns, and unemployment begins to grow, it sets course in that direction. According to BCA Research, there has never been an instance since WW2, when as the rolling 3month average of the unemployment rate turns, and increases by more than one percentage point, a recession has not followed.

CHART 3: 3M ROLLING MOVING AVERAGE OF US EMPLOYMENT, AND THEN SHADED AREAS OF US RECESSION AS DESIGNED BY NBER- FROM 1970 ONWARDS



A Turn in the Employment Cycle reliably leads to a recession

There isn't a central banker alive, past or present, who is not aware of this inconvenient empirical fact. However, modern economies are so complex, that attempting to manipulate them through pulling on the levers of credit and monetary policy does not mean surgical precision. In fact, changes to monetary conditions take time to feed through to the real economy – often cited at 12 – 18 months. In fact, retrospectively we may well look back and point to slowing economic conditions today, a precursor to the next recession, at a time when the US is considering interest rate rises. By the time it's clear that further tightening is no longer advisable, the seeds have already been sown of the next slowdown. At a time when it is no longer easy to discern what the 'correct' or 'equilibrium' interest rate is for modern western economies, we are live to the significant potential for policy error.

CONCLUSION:

Global monetary conditions generally remain favourable, a fundamental requirement for any stock market to make gains. Our liquidity indicators remain in positive territory. Valuations remain elevated in many markets – in fact we have recently seen investors rotate out of highly valued tech growth stocks into cheaper sectors such as banks and energy once more. Investor sentiment is also lofty. Our indicators in the ratio of margin debt to valuation, (measuring the extent to which investors have borrowed to invest into financial markets), and VIX (at measure of investor complacency), argue at least for a pause that refreshes.

Regionally, earnings revisions have been more positive in Europe and Japan than in the U.S. so far this year. Net profit margins are also lower in Europe and Japan, which gives these two regions more room for catch-up. Moreover, unlike the Fed, neither the ECB nor the BoJ are likely to raise rates anytime soon. As we discuss in greater detail in the currency section of this report, this should lead to a weaker euro and yen, giving European and Japanese exporters a further leg up in competitiveness. Lastly, valuations are more favourable in the euro area and Japan than in the U.S., even if one adjusts for differing sector weights across the three regions. We have entered the summer months when historically markets have tended to show some moderation in gains – the relatively calm may not last as perhaps the Trump-Russian investigation gains momentum or the Fed become very vocal about their reducing the holdings of US Treasuries they hold, which is akin to 'quantitative tightening'. Putting into reverse the stimulus that markets have significantly benefitted from in recent years is unlikely to pass without incident. However, beyond any interruption we would look to position for a re-bound before refreshing our glasses for what could be last orders of the bull market next year.

DISCLAIMER

This document is intended only for professional investors and financial advisers. This document is not directed at or intended for the use of retail clients.

The material on these pages is provided for information purposes only; it is not an invitation to invest. Income from investments may fluctuate and investors may not recoup the amount originally invested. Please refer to the relevant Fund Offering documents and/or the terms and conditions for any services offered for detailed information. Please seek relevant professional advice before making any investment decision. Past performance is not a guide to future returns. This document contains forward-looking statements concerning the condition of financial markets, results of investment operations and ARIA Capital Management views. Such statements, expressed or implied, are based on management's current expectations and assumptions, which may change without notice, and are no guarantee of future results, performance or events.

In the United Kingdom Hedge Funds are classed as unregulated collective investment schemes, the promotion of which is restricted by Section 238 of the Financial Services and Markets 2000 (the "Act"). Shares may not be offered or sold in the United Kingdom other than to investors of a kind described in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, namely: firms authorised to carry on investment business under the Act; and institutional and other investors who have experience of alternative, unregulated investments such as hedge funds. This document does not constitute an offer or solicitation to sell shares in any of the funds or provide any investments services mentioned, by anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation.

Persons interested in acquiring funds should inform themselves as to (i) the legal requirements in the countries of their nationality, residence, ordinary residence or domicile; (ii) any foreign exchange controls; and (iii) any relevant tax consequences.

In addition the funds has not been registered under the United States Securities Act 1933 or the Investment Company Act 1940 and is not available for subscription by US investors. Absolute Return Investment Advisers (ARIA) Limited is authorised and regulated by the Financial Conduct Authority in the UK, with Firm Reference number 527557. A Limited Company registered in England and Wales No: 7091239. ARIA and ARIA Capital Management are trading names of Absolute Return Investment Advisers (ARIA) Limited.

2017/084