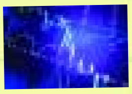
HFM COLUMBUS
Asset Management Ltd

Investment Strategy

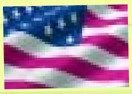
First Quarter 2017

Overview



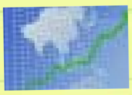
General - The multi-year ‘low growth, low interest rate, low inflation, low returns’ narrative is being challenged by the political sea change brought about by Brexit and Trump. Global economic growth forecasts are being upgraded and the outlook for corporate profits is also improving. Governments and Central Banks now realise that monetary policy has reached its effective limits and there is need for fiscal expansion after years of austerity. The buzz word in financial markets is reflation. Inflation is set to rise as the collapse in the oil price falls out of the rolling annual numbers. This will be most marked in the UK where the fall in sterling will further stoke the inflationary flames. Interest rates are still set to remain low everywhere except for the United States where the Federal Reserve Bank will continue to slowly raise rates. The UK is likely to see slower growth post the Brexit vote but economic data thus far has surprised on the upside. The fall in sterling is seen as a positive for UK equity markets as it will contribute to a double digit jump in corporate earnings. Despite the challenging newsflow most asset classes produced strong returns in 2016. Geopolitics will continue to be a big driver of markets, notably the Trump Presidency and the elections across the Eurozone in 2017. Equity markets were strong in the second half of last year. Sentiment is optimistically ‘glass half full’ leaving stock markets vulnerable to disappointment if reality fails to meet expectation. Government Bonds sold off sharply last quarter from all-time low yields as market sentiment swung from deflation to reflation. We see no value in Government Bonds and continue to favour short duration Strategic Bond funds to largely negate the timing and magnitude of the interest rate cycle. The UK Commercial Property cycle has become increasingly mature but the asset class continues to offer a stable and consistent income stream for investors. *Page 3.*

United Kingdom - The fall in sterling and improved outlook for global growth will produce double digit corporate earnings growth in 2017 which should underpin the equity market. The shadow of Brexit negotiations will hang over UK financial and currency markets. *Page 7.*

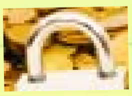


United States - Improving economic and earnings momentum, a reflationary President and the Fed saying the right things on monetary policy, what could possibly go wrong! As usual quite a lot, not least because most of this good news is already discounted in the stock market after a strong end to the year. We expect lower though hopefully still positive returns this year. *Page 8.*

Europe - European markets struggled last year as profits disappointed, Bank solvency issues resurfaced and political developments became more concerning. The Eurozone economy is finally improving and European equities remain a ‘catch-up’ opportunity but as ever in Europe, political turmoil may override any improvement in economic fundamentals. *Page 9.*



Emerging Markets, Asia and Japan - EM markets performed strongly in 2016 but the election of Trump and the stronger US dollar are unwelcome headwinds offsetting improved economic momentum after several difficult years. Japan is seen as the classic ‘global reflation play’ and is currently having a moment in the sun. These markets remain best suited to higher risk/reward investors with a long term time horizon and who can stomach the volatility. *Page 9.*



Fixed Interest - Bond yields rose last quarter signalling that maybe the 35 year bull market is finally drawing to a close. We suspect that yields will be fairly stable in 2017, though with the direction of travel upwards as global economic momentum improves and Central Banks make small and tentative steps away from their super-loose monetary policies. *Page 10.*

Commercial Property - The commercial property cycle has become increasingly mature and returns will be considerably lower than in recent years, driven by rental income rather than capital growth. We do however expect small positive gains for the next few years. *Page 11.*

Commodities - Last year was a bumper year for returns as physical commodities rose strongly and market sentiment towards energy and mining shares turned from bearish to bullish. It is unrealistic to expect such strong gains in 2017 though the asset class has enough positive tail winds to retain its upward momentum. *Page 12.*

Currencies - The main FX driver remains the outlook for growth and monetary policy in the major economic blocs which continues to favour the US dollar, especially post the Trump election where policy should be reflationary for the US economy. The outlook for sterling depends on Brexit negotiations whilst the direction of the euro depends on Eurozone politics. Plenty of imponderables to make the FX market as difficult to call as always. *Page 13.*

General Market Review

Summary:

- The multi-year 'low growth, low interest rate, low inflation, low returns' narrative is being challenged by the political sea change brought about by Brexit and Trump.
- Global economic growth forecasts are being upgraded and the outlook for corporate profits is also improving. Governments and Central Banks now realise that monetary policy has reached its effective limits and there is need for fiscal expansion after years of austerity. The buzz word in financial markets is reflation.
- Inflation is set to rise as the collapse in the oil price falls out of the rolling annual numbers. This will be most marked in the UK where the fall in sterling will further stoke the inflationary flames.
- Interest rates are still set to remain low everywhere except for the United States where the Federal Reserve Bank will continue to slowly raise rates.
- The UK is likely to see slower growth post the Brexit vote but economic data thus far has surprised on the upside. The fall in sterling is seen as a positive for UK equity markets as it will contribute to a double digit jump in corporate earnings.
- Despite the challenging newsflow most asset classes produced strong returns in 2016.
- Geopolitics will continue to be a big driver of markets, notably the Trump Presidency and the elections across the Eurozone in 2017.
- Equity markets were strong in the second half of last year. Sentiment is optimistically 'glass half full' leaving stock markets vulnerable to disappointment if reality fails to meet expectation.
- Government Bonds sold off sharply last quarter from all-time low yields as market sentiment swung from deflation to reflation. We see no value in Government Bonds and continue to favour short duration Strategic Bond funds to largely negate the timing and magnitude of the interest rate cycle.
- The UK Commercial Property cycle has become increasingly mature but the asset class continues to offer a stable and consistent income stream for investors.

You couldn't make it up…

Life is indeed stranger than fiction. Looking back on my forecasts for 2016 I'm struggling to find the bit where I said the UK would vote for Brexit, Donald Trump would become President of the USA, Leicester City would win the Premiership and Ed Balls would become the nation's darling on Strictly. 2016 was truly the year of the insurgent, the protest vote, the anti-establishment, the underdog, the disenfranchised and the little people who won't take it anymore. Nationalism is the new black, globalisation last year's trousers. This rather proves the point I'm always making about forecasts; they're nearly always wrong!

Macro…when the facts change

One of the most important implications of Brexit and Trump is that they are catalysts to break the economic and policy stagnation of the past few years. We have long been proponents of the deflationary ‘lower for longer’ narrative but as JM Keynes famously said ‘when the facts change, I change my mind’ and there is no doubt that this consensus is being challenged. The long term growth trend may still be structurally lower than in previous decades but a cyclical reflation is now in the offing. We have reached a tipping point with Central Banks and politicians realising that super low interest rates have outlived their usefulness. Two decades in Japan, and eight years and counting in the West, have shown that the theory ‘lower rates = higher growth’ hasn’t worked so well in the real world. If economists haven’t worked this out then frustrated and angry voters certainly have with an increasing perception that Central Bank and Government policies are helping the super-rich ‘elites’ and hurting everybody else. This has dawned on incumbent governments so we should see the first thawing in the austerity ice age with some judiciously aimed tax cuts and more government spending, especially in high profile, ‘feel good’ infrastructure.

The current state of play in the global economy is finally more upbeat with forecasts upgraded for the first time in three years and purchasing managers’ indices in the US, Europe and China signalling simultaneous expansion, something last seen in 2014. If Asia’s industrial recovery continues and if the Fed can restrain itself from tightening too quickly and if Trump doesn’t instigate a global trade war then the global economy should at least be moving from lacklustre to moderate growth. There are a lot of ‘ifs’ here but the trend is in the right direction. As always, thank you to Schroders for their latest batch of consensus forecasts. The boffins haven’t got their 2018 act together but we suspect that forecasts when they arrive will see slightly higher growth than 2017 but inflation a touch lower.

The current state of play in the global economy is finally more upbeat . . .

	2016 GDP	2017 GDP	2016 CPI	2017 CPI
World	2.6	2.8	1.9	2.4
US	1.6	2.3	1.3	2.4
Eurozone	1.6	1.4	0.2	1.3
UK	2.0	1.3	0.7	2.5
Japan	0.7	1.0	-0.2	0.5
Emerging Markets	4.2	4.6	3.9	3.5
China	6.7	6.4	2.0	2.0

Return of the Beast

The inflation genie is escaping from the bottle and monthly numbers are going to come as something of a shock after minimal, zero and even negative inflation over the last few years. Nowhere more so than the UK where there is a bit of an ‘inflationary expectations’ contest going on, with the NIESR think tank out in front with a 4% forecast for 2017. The real question is whether the numbers are the beginning of a long-lasting return of embedded inflation or a shorter term mathematical quirk reflecting the doubling in the oil price from its nadir in Feb 2016 as well as the collapse in sterling post the Brexit vote. We think the latter. The UK economy is set to weaken, compounded by falling real incomes as wage growth is unlikely to match inflation, such that UK inflation peaks in the second half of the year before falling back again in 2018. Inflation in the US is looking more entrenched as the tight labour market has pushed up average hourly earnings at the fastest pace since 2009.

Trumponomics

Trump has been somewhat lightweight on detail, and policy is much harder to implement in the real world than it is to rant about on the stump. The likelihood is tax cuts at both an individual and corporate level and an emphasis on job creation, big infrastructure and defence spending and looser regulation. In a nutshell this is pro-growth and inflationary, good for the dollar and equities but bad for Bonds. Whether or not Trump’s ‘personality issues’ and his effect on geopolitics become more important to the market than his economic policy remains to be seen. Trump’s ability to carry out his stated goals may in any case be restricted. The Republican Party has a majority in both the Senate and the House of Representatives so is in theory now able to implement major policy changes but Trump remains at odds with his party establishment which should curb his wilder excesses. Markets are betting that Trump will abandon, or be unable to deliver, the promises that defined his candidacy so we get a nice bit of reflation but without blowing the budget deficit to pieces. That’s the bull story anyway! US trade relations are the main area the President can act unilaterally, a concern given Trump’s rhetoric on tariffs, NAFTA and China. This will

mainly impact emerging markets where both equities and Bonds sold off heavily immediately post the election. There are comparisons being made, wrongly, that Trump will have a Reagan like effect on the economy and markets. Apart from their very different personalities, stock market valuations were at 30 year lows when The Gipper took the reins, 10 year Bonds yielded 14% and the Debt/GDP ratio just 30%; conditions look a lot different now!

Markets….at a turning point?

The whiff of reflation has been very apparent in market behaviour over the last few months as investors sense an environment of improving growth but rising interest rates and bond yields. There are still plenty of factors keeping rates structurally low (Central Bank QE in Europe and Japan, demographics, mountains of debt, pension fund buying) but there is an increasing perception that the direction of travel in Bond yields is now upwards. The Trump agenda of tax cuts and increased spending is unfriendly for Bonds and yields backed up sharply during the last quarter to take the shine off what had previously been a good year for Bond investors. Ten year US Treasuries moved out sharply to 2.50% from a low of 1.37% in July; this pivotal rate is effectively 'the global price of risk' and drives behaviour in all asset classes as well as the price of borrowing worldwide, not least in mortgage markets. This is not though a 'regime change' on a par with 1982 when Reagan and Thatcher began the era of globalisation and Paul Volker at the US Fed began his assault on inflation. More likely today's market is signalling that the obsession with deflation had become too extreme and Bond yields had fallen too low. It is somewhat ungracious of me to draw such an unflattering analogy but Janet Yellen is the proverbial 'fat lady' whose singing will signal when the great 35 year Bond bull market is finally over. Gentle, well signalled rate rises spread over time will keep markets relatively relaxed and Bond yields capped. A more hawkish rhetoric and acceleration in the timing of rate rises could be very painful, especially as ultra-low Bond yields leave so little margin for error.

A significant outcome of the 'lower for longer' era has been a global earnings recession stretching back to 2014, focussed on commodities and financials. The outlook for profit growth is now finally improving as the base effect of collapsing commodity prices falls out of the annual rolling numbers and the steepening yield curve helps the profitability of financials. Global profit growth is forecast to be 12% in 2017 and higher still in the UK, where many companies are beneficiaries of the collapse in sterling. Forecasts invariably move from NW to SE but we should still see markedly improved earnings which make P/E valuations less demanding. It's not just the index level of equity markets that has been important over the last few years but also what has been going on inside the market. We have been banging the drum for several quarters about the trend for cyclical recovery and value stocks to outperform the quality growth 'bond proxy' stocks which have dominated the market cycle since 2007 and this trend has been accelerated by the Trump victory. Any asset class which had been 'bid up' in the excessive hunt for safety or yield has taken a bit of a clobbering in the new Trump era, including Government Bonds, EM Debt and Gold. Whatever the reason, the market eventually reverts to mean.

A challenge for portfolio construction is that if yields continue to rise (i.e. prices fall) then Bonds are no longer able to fulfil their multi-decade role in portfolios as a diversifier from equities. We already have significantly lower Bond weightings in Model Portfolios than traditional asset allocation models would suggest but finding alternatives is difficult. Increasing cash helps capital preservation but provides no return whilst absolute return funds remain a mixed bag in terms of return, volatility and drawdown protection.

A Tale of Two Currencies

When I wrote in the last quarterly 'sterling looks stable at lower levels' what I should have written instead was 'sterling looks stable at lower levels…unless Theresa May plays to the Hard Brexit crowd in which case sterling will fall to a 168 year low.' Sterling fell by around 20% last year which is not good news if you are planning an overseas holiday or a low earner spending most of your income on imported food and energy. There are, in theory at least, some silver linings in this playbook. A lower sterling could bring the blessings (mixed depending on your point of view) of higher interest rates, lower house prices and at least the chance of a manufacturing renaissance as a markedly weaker sterling more than offsets the effect of any Brexit tariffs on UK exports. The UK's huge current account deficit, long the Achilles heel of sterling, may finally start to diminish.

If sterling is on the naughty step then the school swot is the US dollar. The greenback had stalled for most of 2016 but put on a spurt post Trump and is now storming away again against its major trading partners. A strong dollar is usually not particularly good news for financial markets. It reduces US earnings, as many of the S&P500 companies have large overseas revenues, and it hurts emerging markets as the cost of servicing their dollar denominated debt rises, potentially leading to capital outflows and higher interest rates. There are now a couple of other currencies vying to take the dunces cap from sterling. The outlook for the Euro is problematic given the number of political banana skins the Eurozone is facing this year whilst interest rate differentials are widening between Japan and everyone else, which is weakening the yen.

Scores on the Doors

IMA Sector Average	2016 (%)
UK All Companies	10.8
UK Equity Income	8.8
Europe ex UK	16.4
North America	29.3
Japan	23.3
Asia Pacific ex Japan	25.6
Global Emerging Markets	30.8
UK Gilts	11.1
UK Index-Linked Gilts	25.4
Sterling Corporate Bonds	9.1
Sterling Strategic Bond	7.3

Figures from Financial Express Analytics

Brexit? So what. Trump? Don't care. Financial markets trampled over the doom-mongers and naysayers last year and looked instead to a new world of stronger economic growth and double digit corporate profitability. All asset classes bar Commercial Property produced substantial returns with Bonds formidable in H1 before stumbling somewhat in the last quarter and equities racing away after the summer. Currency has been a big factor with sterling very weak against the Yen (23%), Euro (16%) and US dollar (19%). This has massively enhanced returns from overseas funds and in the case of Japan and Europe converted minimal returns from these markets in local currency into pleasingly strong returns for the UK domiciled investor. Wall Street is at pretty much an all-time high so bumper returns with the strong dollar added in. Whether the reality will match the bullish economic expectation remains to be seen but it was nice to see healthy portfolio returns in 2016 against a background of challenging newsflow.

The switch within equity markets away from predicable growth to value/recovery continues with energy, natural resource, industrial and technology stocks all strong but healthcare and consumer staples sectors, the so-called 'bond proxies', struggling. The biggest turnaround has been in financials which in the last few months have gone from pariahs to market darling with banks and insurance companies the beneficiaries of a steepening yield curve. Large stocks have outperformed their smaller brethren with the FTSE 100 index gaining 19.1% last year but the mid-cap, more domestically focused FTSE 250 index returning 6.7%. Absolute Return funds have in general been poor but the conservative multi-asset funds we favour have done well, buoyed in some cases by holdings in Gold and index-linked securities. In a classic reversion to mean the most hated asset class in January 2016, commodities, turned out to be the best performer.

Conclusion….All change?

Last year was bizarre, confusing, scary but surprisingly profitable for investors as the 'lower for longer' narrative of the last five years was challenged by the new reflation story. Risks, but maybe also rewards, abound. Take your pick from Trump, European elections, Chinese growth, Brexit negotiations, Italian Banks, rising oil and commodity prices, and seesawing currencies. A lot of things changed in 2016, this year will see the repercussions slowly beginning to appear. The opportunity is that with profit growth returning, equity markets continue to looks through the problems and climb the 'wall of worry'. However, having embraced the siren call of reflation, markets are currently in 'glass half full' mode so reality needs to meet expectation otherwise there is plenty of room for disappointment. This looks like a recipe for oohs and aahs, for swings and roundabouts and another year of unpredictable volatility with forecasts made in January looking embarrassing by February at the latest. For an investor like me who likes quiet times and snoozing by the riverbank this is not good news.

We are neither bullish nor bearish on markets but my sense is that following an above average 2016, returns over the next few years will be lower than historic norms with Bonds in particular a difficult asset class in which to make any money. We will continue to build portfolios that are on the cautious side of neutral for each asset allocation to best protect capital yet hopefully, as last year, still able to capture plenty of upside when the wind blows in the right direction.

A lot of things changed in 2016, this year will see the repercussions slowly beginning to appear

Specific Market Reviews: United Kingdom

- Politics in the UK is pretty rum these days. Brexit was the biggest political crisis for decades with heads rolling in all directions. We now have a Tory leader calling for more control over business and a bigger involvement by the state in almost every aspect of daily life. Talk about pushing for the centre ground, Theresa May's Conference speech wouldn't have looked out of place had it been delivered by Ed Milliband a couple of years ago. The Guardian is (gleefully) referring to it as 'Red Toryism' and we have a new social grouping, the JAMs (just about managing) that Theresa is going to prioritise at the cost of those who previously had all the jam, presumably all the financial jonnies demonised by the popular press. The new broom also considers monetary policy to be at its limits, that ultra-low interest rates are doing more harm than good, and that some fiscal support is necessary.
- The beleaguered Mark Carney has had to row back on his 'Project Fear' forecasts for economic growth. The latest Bank of England prognostication has upped growth in 2017 from a miserly 0.8% to a healthier 1.4%, though cut expectation in 2018 from 1.8% back to 1.5%. The BoE also forecast that inflation will be 2.75% this year and not return to 2% till 2020, the well-fingered culprits being energy and sterling. There revisions imply that the Bank considers the impact of the Brexit vote will be considerable, but felt later than expected. The Office for Budgetary Responsibility is singing from the same sheet, also expecting 1.4% growth this year followed by 1.7% in 2018 and around 2% for each of the next three years with the caveat that the Brexit negotiations may throw a spanner in the works.
- The Autumn Statement from the Chancellor Philip 'Spreadsheet' Hammond adopted a sober though cautiously optimistic tone and was very 'on message' emphasising that 'Britain remains open for business' post the Brexit vote and there was a nod to populist feeling with an increase in the Government's short term spending plans. The Statement was attacked for being bland and timid but Hammond has little room for manoeuvre in his fiscal easing given the parlous state of Government finances. In truth, as nobody has any idea as to what a Brexit is going to look like it's pretty difficult to do much fiscal planning anyway.
- Carney may be guiding us to believe that there are no interest rate rises in the offing but Building Societies and Banks aren't listening and the era of rock bottom mortgage rates is coming to an end. Several lenders have already raised rates or removed their most alluring offerings. Swap rates (the cost of fixed rate borrowing by lenders) plummeted post Brexit sending mortgage rates to record lows but have risen sharply since August.
- Earnings growth is back. For the first time in five years FTSE All Share rolling 1 year forward eps momentum is positive not negative. Earnings in 2017 should see a double digit gain, partly due to the recovery in energy and mining earnings but also from the big fall in sterling. For this to remain a key driver for stock prices, earnings growth needs to become sustainable because companies have become more competitive due to the fall in sterling rather than just being a one-off 'paper gain' due to the translation effect.
- Similarly, dividends are expected to increase by around 10% this year as around 40% of pay-outs by UK listed firms are in dollars or euros which are now worth considerably more in a windfall gain more following the sterling collapse.
- Equities ended the year with a traditional 'Santa rally' resulting in a pleasing return of 19.1% for the FTSE100 index for 2016 as a whole. Smaller, more domestic, stocks did less well with FTSE250 rising 6.7%.
- The improved earnings outlook has helped the market valuation despite the big index rise with the FTSE100 P/E falling to 15x forward earnings, making it relatively more attractive than Europe and the US, which have not had this currency aided earnings bounce. The dividend yield is a very healthy 3.6%.

For the first time in five years . . .
earnings momentum is positive not negative

Summary: The fall in sterling and improved outlook for global growth will produce double digit corporate earnings growth in 2017 which should underpin the equity market. The shadow of Brexit negotiations will hang over UK financial and currency markets.

United States

- The great adventure begins. As America takes a firm step to the right the result could be a country of lower taxes, lighter regulation and a smaller state providing the impetus for individuals and business; or instead a stridently populist, isolationist US with the state setting a harsh tone, most notably on immigration. Will the bark be worse than the bite? As one smart cookie put it, the voters took Trump seriously but not literally whereas his critics took him literally but not seriously. Let's hope that Trump proves to be a Ronald Reagan, setting the mood but leaving the details to a competent team that can find a pragmatic and reasonable consensus delivering 'Trump-lite' policies that echo the tone of The Donald but without the harshness and bigotry. Time will tell and as we mentioned in the main body of text, the comparison is invidious as Reagan inherited an economy with far less debt and with market valuations at three decade lows, not three decade highs.
- The economy is finally picking up a head of steam with the monthly releases of jobs growth, retail sales, consumer confidence and housing starts consistently perky and consensus forecasts for 2017 GDP growth edging upwards. Not surprisingly the Federal Reserve Bank raised rates by 0.25% in December to re-start the upward trajectory in short term rates that had been put on hold last year due to various economic or political traumas. The Fed are projecting three small rate rises this year so let's see if they are more accurate than last year when the four rate increases Janet Yellen predicted ended up being just the one at the very end of the year.
- Earnings, earnings, it should always be about earnings and for once it's a more pleasing picture. S&P500 earnings in Q3 rose by around 3% having previously fallen in year on year terms for the last five quarters whilst sales revenues rose for the first time since the last quarter of 2014. Current forecasts are for earnings growth of 3.2% in Q4 2016 and revenue growth of 5% which means that earnings will have been pretty much flat for 2016 as a whole. Looking into 2017 the picture is much brighter as the big negative of 2016, energy sector earnings, becomes a positive due to the much lower base level for annual comparison. Much touted cuts in corporation tax should also boost earnings whilst companies repatriating their big offshore cash mountains could well use them for buying back shares or increasing dividends. According to Factset, analyst forecasts are for earnings growth of 11.5% and sales growth of 6%, probably way too bullish (as usual) but a step in the right direction and helps to bring the S&P500 12 month forward P/E down to 17%. This is well above the ten year average of 14.4% but not as grossly overvalued as many commentators like to portray.
- The Dow Jones and the S&P500 indices scaled all-time highs last year, powered in the last few months by hopes of a new Trumpian age of reflation and growth. It may prove tougher sledging this year but as long as earnings momentum remains positive and Trump does nothing stupid then the market looks in reasonable shape to produce a positive return.

*The economy is finally picking up a head of steam . . .
consensus forecasts for 2017 GDP growth
are edging upwards*

Summary: Improving economic and earnings momentum, a reflationary President and the Fed saying the right things on monetary policy, what could possibly go wrong! As usual quite a lot, not least because most of this good news is already discounted in the stock market after a strong end to the year. We expect lower though hopefully still positive returns this year.

Europe

- The Eurozone economy is chugging along with GDP expanding by an annual rate of 1.7% in the first three quarters of 2016. Unemployment is down from 10.6% to 9.8% in the last year with big declines in the former crisis countries of Spain, Portugal and Ireland and even poor old Greece seemingly on the mend. Momentum definitely seems to be improving, with the November PMI survey for November the highest of the year.
- Incumbent European politicians will be sleeping ever less easily in their beds following Brexit, Trump and the resignation of the Italian PM Renzi following the 'no' vote in the constitutional referendum. There are elections in the Netherlands (March), France (May) and Germany (September) this year and probably at some stage in Italy as well. The smaller, nationalist parties all over Europe will be licking their lips; never before has the unity of the EU been so threatened.
- The ECB has extended its quantitative easing (QE) programme until at least December 2017 though it will reduce the monthly amount of Bonds it will purchase from March onwards. Over the last few years the ECB has taken the political risk out of the Eurozone bond markets by being the buyer of last resort during times of upheaval, and given the electoral calendar this year an extension of QE was inevitable. Mario is in a bit of a spot really, keen to tentatively withdraw from QE as he appreciates that the limits of monetary policy have now been reached, but not able to exit because he wants to keep Bond yields low and liquidity ample to be supportive of growth and political stability.
- European stock markets rallied strongly in the last couple of months of 2016 but still only delivered small gains in local currency terms for the year as a whole. The DJ EuroSTOXX index rose 1.2% for the year in local currency terms, 4.7% when dividends are added in. European funds though produced healthy double digit returns for UK investors in sterling terms due to the pound being clobbered post the Brexit vote.
- There are a lot of ifs, buts and maybes in forecasting European market returns this year, mostly revolving around politics and the threats to the stability of the Eurozone and the single currency. There is a bull case out there if Europe maintains its recent economic growth momentum and global growth continues to strengthen as Europe has a plethora of export oriented companies. Liquidity is plentiful thanks to the ECB and a weaker currency will aid the exporters. European markets have badly trailed the US S&P500 index in local currency terms over the last 6 years and, as always with this troubled continent, hope springs eternal.

There are a lot of ifs, buts and maybes in forecasting European market returns this year, mostly revolving around politics

Summary: European markets struggled last year as profits disappointed, Bank solvency issues resurfaced and political developments became more concerning. The Eurozone economy is finally improving and European equities remain a 'catch-up' opportunity but as ever in Europe, political turmoil may override any improvement in economic fundamentals.

Emerging Markets, Asia and Japan

- It had all been going so well. Dovish Central Banks, falling Bond yields, a stalling dollar, higher commodity prices, a more stable Chinese economy, better economic survey data from Asia, fading recessions in Russia and Brazil, and returning investor interest. The headwinds of previous years had become tailwinds. Then along came The Donald! Not only will higher US yields and a stronger dollar make life more difficult for EMs but Trump's policy of 'America First' could lead to the US reneging on trade deals and imposing tariffs targeting specific countries. For the export centric EMs this is the worst possible news and will continue to be a Sword of Damocles hanging over what is otherwise a far more promising outlook for the emerging markets after several years of gloom.
- Concerns over China's growth persist but further fiscal support and monetary easing is expected in the run up to the National

Congress in November to provide President Xi with plenty of political capital against any potential power struggle. Consensus GDP forecasts are being revised up slightly to 6.4% for 2017. The policy mix of the stimulus is likely to be biased towards the fiscal side, the Central Bank being opposed to much further monetary easing owing to currency and asset bubble concerns. With a stronger US dollar and higher US rates a continued but only gradual depreciation of the renminbi is likely. China hardly appears the currency manipulator of Trumpian depiction!

- The MSCI EM forward P/E is 12x which is cheap compared to developed markets and in line with the 20 year average on an absolute basis. EMs have valuation support and earnings momentum has been improving for the first time in a number of years but for their strong rally of 2016 to continue EM markets need Chinese policy to remain supportive, the Fed to be gentle in its tightening, dollar strength to be muted and no crazy trade policies from the Trump administration.
- Everyone is getting bullish about Japan again. The yen was super strong for most of last year which hampered stock market returns but it has weakened significantly against the dollar post Trump which is a boost for Japanese corporate earnings which have a heavy export bias. With its large financials and industrials weightings Japan has a big value/cyclical tilt so all this talk of global reflation is good news. Investing in Japan in 2016 was certainly a game of two halves, the Topix index falling by 20% from January to July but then rebounding strongly, especially in November and December, to end the year pretty much flat. For the sterling based investor Japan was actually a very good market in which to be invested, the strength of the yen resulting in a return of over 20%.
- The Bank of Japan is targeting a zero 10 year Bond yield so there is plenty of liquidity and despite Abenomics being a bit of a damp squib Japan has not been quite the two decade long basket case of popular perception. The stock market has certainly been rubbish and GDP growth anaemic but real median incomes have been rising at twice the level of the US and unemployment is only 3%. Nor is there any sign of the anti-establishment fervour that is sweeping the West. Maybe Japan is finally getting its confidence back, the Olympics are in Tokyo in 2020 and a Japanese company Rakuten is about to become the sponsor's name on the iconic Barcelona footy shirt. Japanese equities trade on a P/E of only around 12 despite earnings and dividends rising, and the Bank of Japan is buying up 3% of the stock market per year which always helps.

Summary: EM markets performed strongly in 2016 but the election of Trump and the stronger US dollar are unwelcome headwinds offsetting improved economic momentum after several difficult years. Japan is seen as the classic 'global reflation play' and is currently having a moment in the sun. These markets remain best suited to higher risk/reward investors with a long term time horizon and who can stomach the volatility.

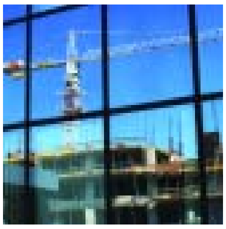
Fixed Interest

- 2016 was a strange old year for Bond market investors. The first three quarters saw large gains as Government Bond yields plummeted to all-time lows as financial markets became ever more obsessed with deflation. All change though in the last few months. A whiff of reflation in the air, calls for more expansionary fiscal policies, an understanding that the limits of monetary policy have been reached and Trump in the White House led to sharply higher yields and steeper curves. Indeed, such was the reversal in US Treasuries that 10 year paper made losses on the year as a whole. Apart from the US, 2016 was still a good year to have been a Bond investor, just not from September onwards.
- In addition to the global retreat in Bonds we had our own local issues on the home front. Overseas buyers are unsettled by Brexit negotiations and the plummeting currency, which is a stoking inflationary fears in an economy that is traditionally very inflation prone. 10 year Gilt yields rose from 0.6% to 1.4% in what felt like the blink of an eye. In a theoretical world, inflation hitting 3% next year implies a 10 year Gilt yield of at least 2.5%. However, the inflation number is somewhat false given it is a mathematical quirk resulting from the huge swings in the oil price and the collapse in sterling rather than heralding a long term systemic inflation problem. Nor is it a good idea to fight a Central Bank and the BoE is not going to stand aside and let Gilt yields rocket when UK growth is slowing down. It is difficult to envisage 10 year Gilts trading much above 1.5% in the medium term.
- Credit spreads tightened last year, global investment grade by 35bps, EMD (US) by 40bps and the higher risk/reward global High Yield a whopping 200bps as investors' ramped up their risk tolerance in a desperate hunt for income. We expect spreads to be relatively stable in 2017.
- Index-linked Gilts have had a storming year, benefitting initially from their long duration as conventional Guvvie yields plummeted in the first half of the year and more latterly from rising inflationary expectations, though they still gave up some ground alongside conventional Gilts in the last quarter.
- Our strategy of maintaining a relatively short duration positioning in the Fixed Income component of client portfolios over the last few years has been overly cautious. We have made some decent returns with minimal volatility but would have made greater returns

if we had owned long duration Government or Corporate bonds. However, it remains our long held view that Bond yields offer no value and yields backing up significantly last quarter resulted in substantial losses for holders of long dated paper. By sticking with typically shorter duration Strategic Bond Fund we are looking to negate the effects of the interest rate cycle and insulate portfolios against any pick-up in yields.

Summary: Bond yields rose last quarter signalling that maybe the 35 year bull market is finally drawing to a close. We suspect that yields will be fairly stable in 2017, though with the direction of travel upwards as global economic momentum improves and Central Banks make small and tentative steps away from their super-loose monetary policies.

Commercial Property



- With some considerable relief I can say it is back to business as usual (fingers crossed) now that the daily dealt ‘bricks and mortar’ funds have re-opened for subscriptions and redemptions following their suspensions in the aftermath of the Brexit vote and all dilution/fair value levies have been removed. The funds fell by around 7% in 2016, mostly due to the price swing from offer to bid as net asset values have been pretty much flat.
- Commercial Property remains in a period of shallow correction post Brexit as the market comes to terms with its implications. The initial reaction was one of despair with a 2.6% fall in property prices in July and baleful forecasts for the foreseeable future but prices have since stabilised. The market has been far more resilient than the doom-mongers expected with only small monthly falls in capital values in the last few months which have been offset by the rental income return. The IPD UK Monthly Property Index actually rose by 0.8% in November meaning that the year to date return for 11 months of 2016 was a positive 1.5%. Transactions have also recovered more quickly with £9.4billion of assets sold in the third quarter. Sterling’s weakness is no doubt a big part of the picture with overseas buyers responsible for much of the activity but UK private equity, pension funds and local authorities have also keen to pick up stock.
- Central London offices are expected to fare the worst in relative terms though again to be more resilient than first thought. Demand for big pre-lets is on hold post the referendum but there is no sign as yet of any relocation of financial institutions to Frankfurt or Paris. London accounts for around a fifth of the IPD index with a meaningfully lower yield and more challenging fundamentals but the outlook for the rest of the UK is healthier. Valuations in the industrial sector are underpinned by a lack of quality supply whilst there is still robust demand from retailers for smaller warehouses close to towns to provide online shoppers with tighter delivery windows. A weak sector is large offices with long 15 to 20 year leases, the big corporate stuff in effect, with businesses loath to make big commitments till there is a bit more transparency on what a post Brexit UK will look like.
- I had a meeting several weeks ago with Fiona Rowley who manages the £4bn M&G Property Portfolio to discuss the management of the portfolio post the lifting of its suspension and her outlook for the sector. She is bearish on pretty much anything to do with London (as above!), neutral about the South East but relatively upbeat on the rest of the UK especially retail warehouses and supermarkets. In terms of returns, she is expecting the IPD index to return 2.7% this year (2.3% fall in capital values as the market continues to slide offset by the 5% income return), 5.6% return in 2018 but then a pick-up to between 8% and 10% for 2019 through to 2021 as capital returns become positive again. Maybe a tad optimistic for the later years I reckon, especially as rental growth is going to come under pressure from lower GDP and weaker tenant demand. Rental growth had been expected to be in the order of 3% or more per annum when forecast were published in April but recent forecasts are 1% or less across all sectors and rental growth actually set to fall in Central London offices.
- In short, most of the fundamentals that underpin the property market are still relatively solid. Compared to 2008 there is less oversupply, tenant demand is stronger, there is far less debt financing and the banking system is in a much healthier state with credit being made available rather than being withdrawn. The current yield on the IPD index is 5%, low by historic standards but attractive in relation to other fixed income assets. Commercial Property offers a consistent, long term, quasi-inflation-linked stream of income in a world where yield is a scarce and highly sought after commodity.

Summary: The commercial property cycle has become increasingly mature and returns will be considerably lower than in recent years, driven by rental income rather than capital growth. We do however expect small positive gains for the next few years.

Commodities

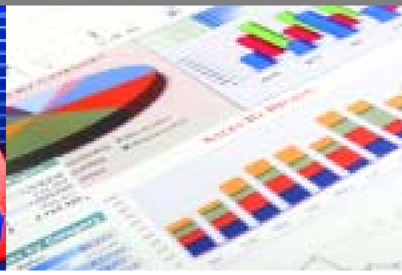



- Oil appears likely to trade in a range between US$40bl/ and US$60/bl with the swing factor being US shale companies. At the bottom end of the range these companies scrap rigs and cancel drilling plans and at the top end they do the reverse. OPEC, in effect Saudi Arabia, changed tack in November with its first meaningful supply cut since 2001 which led to a an immediate 10% bounce in the oil price and is a major support going forward. The intention will be to bolster prices enough to increase OPEC revenues but not to the extent that it encourages the shale boys to get drilling again, a rather tricky tightrope. The biggest threat to my expected range is probably that the world's worst forecaster of the oil price, Goldman Sachs, concurs with my thinking in predicting an average price of $55/bl for the first half of this year. And the outlier? That a combination of the production cuts made last year and OPEC discipline (oxymoron?) results in a surge in the oil price back towards $100/bl, I haven't seen that in too many forecasts!
- After basking in the sun for most of 2016, Gold was another victim of the Trump regime change. Geopolitical uncertainty and rising inflationary expectation should have been right in Gold's wheelhouse. In practise though the markets are turning out to rather like Trump after all, a strong dollar never seems to be a friend of the yellow metal and probably most importantly the opportunity cost of higher Bond yields is a negative for an asset which pays no income.
- Last year was stunning year for investing in commodities with bumper returns after several years of losses, with a new commodity cycle bull market based as reduced production and (hopefully) increased demand. More stable economic data from China, loose global monetary policy and a weaker US dollar until the final quarter proved useful tailwinds. The physical commodities themselves rose in price, notably oil but there were also big gains in copper, lead, coal and iron-ore. The largest returns though were often through investing in energy and mining companies, many of which had looked on the verge of bankruptcy a year ago. Mining company capex has fallen dramatically since 2012 with managements forced to take their painful medicine, slashing and in some cases passing their dividends and embracing 'shrink to survive' strategies by shedding non-core operations. There is plenty of 'execution risk' in the miners' survival plans but it is a significant step in the right direction and share prices have reacted accordingly.
- It is not realistic to expect such bountiful returns from the asset class again in 2017. Last year was an 'inflexion point' with sentiment changing from deeply bearish to super bullish and in such conditions the biggest returns are made. Commodities need economic growth momentum to remain positive and mining and energy companies to retain discipline in their production and exploration. Should these tailwinds remain then there is no reason why 2017 should see some decent returns, though the 'easy money' stage of the nascent bull market is now behind us

2016 was an 'inflexion point' with sentiment changing from deeply bearish to super bullish

Summary: Last year was a bumper year for returns as physical commodities rose strongly and market sentiment towards energy and mining shares turned from bearish to bullish. It is unrealistic to expect such strong gains in 2017 though the asset class has enough positive tail winds to retain its upward momentum.

Currencies



- The US dollar bull market stalled for most of last year as the Fed sat on its hands but the greenback is starting to build up a head of steam again hitting a 14 year high against a basket of major trading currencies. The US economy remains the strongest of the major developed countries and the Fed is signalling three small rate rises this year whereas the ECB and BOJ remain in emergency easing mode. Trump's reflationary policies will increase the 'policy gap' which should be increasingly positive for the dollar assuming the interest rate differential argument holds sway. The gap between US and German 10 year Bonds is now well over 2%, the highest since 1989. The Bank of Japan's targeting of a 0% yield on ten year JGBs means that the yen, which had been very strong for most of 2016, is suddenly looking far less attractive against all currencies and it fell precipitously in the final quarter.
- I discussed the great sterling crash in the body of the newsletter with future direction almost wholly dependent on Brexit negotiations. If the Tory Conference marked the peak of Hard Brexit and we begin to see some UK compromise, as seems likely, then sterling should recover somewhat; if the tone becomes harsher then sterling will be back in the doghouse. In 2016 sterling fell by 23% against the yen, 19% against the US dollar and 16% against the euro despite something of a rally in the last couple of months of the year. Famous last words, but having already taken such a battering in 2016 sterling looks likely to be stronger rather than weaker this year against the major currencies bar the dollar.
- All the FX market focus post the Brexit vote has been how bad it will be for the UK but the Euro looks set to replace sterling in the cross-hairs of the market. The Eurozone is in a very uncomfortable place politically, more so following the Renzi resignation in Italy, and closer to breakup than at any time in its history.
- Out of the mouths of children and innocents….my teenage daughter has just blown a hole in my beloved currency predictor the Economist Magazine's Big Mac index by countering with her own iPhone index. Izzy is an industrious young lady, studying hard at college during the week and then raking in the pennies working weekends as a barista (she does a lovely flat white) together with a lucrative side-line babysitting for the glitterati of Haywards Heath. All this moola gives her the option of upgrading to an iPhone 7 though she is giving this a miss hoping for better things from the iPhone 8, one for you techies to mull over. However she has noticed that the UK starting price is £599 whilst the equivalent phone in the States is US$649 implying an exchange rate of £1/US$1.08 making the pound still looking overvalued, unlike the Big Mac rate of around $1.65 implying that sterling is seriously undervalued. Given the international ubiquity of the iPhone then arguably it is just a legitimate comparator as the Big Mac. Hmm.

having already taken such a battering in 2016 sterling looks likely to be stronger rather than weaker this year against the major currencies bar the dollar

Summary: The main FX driver remains the outlook for growth and monetary policy in the major economic blocs which continues to favour the US dollar, especially post the Trump election where policy should be reflationary for the US economy. The outlook for sterling depends on Brexit negotiations whilst the direction of the euro depends on Eurozone politics. Plenty of imponderables to make the FX market as difficult to call as always.

Ten Years on….

Everybody, expert and amateur alike, is rubbish at making economic and stock market forecasts'

I began working for HFMColumbus on December 1st 2006 and doesn't time pass quickly when you're enjoying yourself. For lovers of nostalgia, this is what the world looked like when I first clocked on.

- Take That had their ninth number one single with Patience
- The English cricket team departed for an overseas series under the leadership of Freddie Flintoff and suffered a 5-0 whitewash…not much change there then.
- Man Utd topped the Premiership which included Portsmouth in 4th place and Reading in 6th as well as Bolton, Sheffield Utd, Wigan, Blackburn and Charlton. A 'wally with a brolly' had just been appointed manager of the England football team
- Alleged war criminal, self-aggrandiser and money-grabber extraordinaire Tony Blair (remember him) was in No.10
- Not a great year for movies with Pirates of the Caribbean (Dead Man's Chest), Night at the Museum and Casino Royal topping the box office. German cinema's The Lives of Others made us appreciate being born in a democracy.
- TV saw the debuts of The One Show, Dancing on Ice, the fabulous Life on Mars and guilty pleasure Waterloo Road.
- I paid an outrageous price for my Southern Rail season ticket, and pay an even more outrageous price today... but at least back then the trains turned up.
- The FTSE closed at 6021, Gold was US$330/oz., the Base Rate was 5%, 10 Year Gilts yielded 4.6%, and sterling bought you $1.98 and €1.48. Blimey, the holiday pound went a long way back then

It's been a pretty traumatic decade for the global economy and financial markets, dominated of course by the 'Great Financial Crisis' in 2008 which was early on my watch and whose ripples are still being felt to this day. Financial markets appear ever more challenging but there are some immutable principles which investors can follow to keep their portfolios in good order and indeed, some handsome gains have been made since 2009. I wrote about these principles at the start of my tenure and repeat them again as they are just as relevant today. Investing can seem a complicated business, full of unfathomable mathematical ratios and macroeconomic gobbledygook. An investor's best resource is their own common sense, something which goes sadly AWOL in many otherwise intelligent people the moment they start making investment decisions.

Here are some guidelines we try to follow

- **Control Your Emotions.** Investors can be surprisingly counter-intuitive, buying assets after they have risen strongly and selling them after they have fallen heavily. Greed and Fear in other words. Investors typically place too much emphasis on what has just happened and simply extrapolate current trends. Investors need to be emotionally self-aware and avoid over-confidence, selective memory syndrome and the seeking of instant gratification.
- **Avoid the 'Prediction Addiction'.** Everybody, expert and amateur alike, is rubbish at making economic and stock market forecasts but investors still feel compelled to make and then act on these shots in the dark. Investment is not a black and white, precise science. You should be thinking in terms of a range of outcomes and the risk attached to each outcome if you make the wrong choice. Sitting on the fence with a well-diversified collection of asset classes and funds is just fine; 'if in doubt do nowt' as my Yorkshire forbearers would say.
- **Get Rich Slowly.** Investment should be calm and measured, even boring; it should not be hectic and stressful and a right old drama all the time. That grand old dame the Foreign and Colonial Investment Trust coined the advertising slogan 'Get Rich Slowly' and this remains excellent advice. Time and Patience are the investor's best friends

Risk control is protecting the real value of investor capital, not chasing the possible consequences of unpredictable outcomes

- **Wait for the 'fat pitch'.** If you do wish to be more tactical in your approach then you should at least wait (in classic US market jargon) for the fat pitch, or the half volley as we cricket playing nations would call it. I prefer the comparison of being in a poker game. You shouldn't be playing every hand, instead just keep folding until you get some very good cards.
- **Don't fight the market.** You are a long-term investor not a trader so accepting volatility and staying in the game achieves the long term returns which the market historically delivers. Markets are on the whole 'efficient' with the big and scary market moves frequently just short term panic melt-ups or down which are soon corrected by mean-reversion and should not concern the long term investor.
- **Understand Risk.** Ignore investment speak definitions such as 'volatility' and 'value at risk'. Instead consider 'do I understand this investment' 'how certain am I of the outcome' and 'how much I could lose if it goes wrong'. Risk control is protecting the real value of investor capital, not chasing the possible consequences of unpredictable outcomes. Two golden rules are 'seeking a higher return increases the risk of loss' and 'targeting a return higher than cash will involve the risk of a capital loss'
- **Be Realistic.** The magisterial Barclays Equity/Gilt Study tells us that UK equities have produced an average return after inflation of 5.5% over the last 50 years and Gilts 2.5%. This should be your annual expectation of return, anything more is a bonus. Returns back to 1899 tell a similar story over a period involving two world wars, a fair number of financial crises and more economic booms and busts than you can shake a stick at.
- **The 7/10 Rule.** If you get 7 out of 10 investment decisions right and don't allow the 3 you get wrong to blow up your portfolio then you are doing a decent job.
- **Simple, Liquid, Transparent.** You need to be in control of your investments and if you can't buy and sell them on a daily basis then they are controlling you. Similarly, if you don't understand an investment then it is also controlling you. If you accept some illiquidity in an investment then it should have substantially superior risk/reward characteristics to existing liquid alternatives to compensate you for this loss of control.
- **Let it go.** You are meant to be growing and protecting your wealth over the long term, not predicting every market toss and turn. You could always have bought something better, be it Korean smaller companies, frozen orange juice futures (one for the movie buffs) or the Polish Zloty but get over it. You should only worry about what you do own, not what you don't. Obsessing about missed opportunity is emotionally destructive. So long as your portfolio is meeting its long term objectives then you can relax and ignore the noise.
- **Embrace Clichés.** What they may lack in analytical rigour they make up for in common sense. My favourites include 'buy when sleeping, hold when creeping, sell when leaping', 'markets climb a wall of worry', 'all turkeys fly in a gale', and 'buy straw hats in winter'.
- **'There's no crying in Baseball'.** Accept when things go wrong, learn from them and then move on. Understand whether you screwed up because you didn't do enough due diligence (shame on you), did the work but still made the wrong call (me on Bonds!), were genuinely unlucky/act of God (rare but Trump and Brexit arguably come into this category) or were just plain stupid. Don't make the same mistake twice and don't re-write history to justify past poor decisions.

And finally

- Never think you've cracked this investing malarkey and never be complacent; the market makes fools of all of us in the end.

Written by Rob Pemberton,
Investment Director

You are meant to be growing and protecting your wealth over the long term, not predicting every market toss and turn

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