ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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Most people seem glad to have seen the back of 2016, but it wasn't all bad. The wild tiger population grew for the first time in a century, world hunger dropped to the lowest level in over 25 years, giant pandas came off the endangered list, HIV may well have found a cure and Team GB had its best-ever haul of gold medals. Quite how widely each of these stories were reported wasn't necessarily related to the importance of the underlying subject. It therefore may come as a surprise to learn that the UK's stock market (based on the top 100 companies) was the second-best performer across the developed world last year. Including dividends, the UK index recorded a gain of 19.1% and only Toronto was ahead by more, notching up a 21.1% return. That said, although other markets lagged, the sharp fall in sterling has boosted international returns for UK investors and as the chart overleaf shows, US and emerging markets provided near 33% gains for UK investors. Even bonds threw in a 10% plus return, which is a huge move by historic standards. In all, it has been a fantastic year for nearly everyone with investments other than cash, yet the whole episode has felt distinctly joyless.

The UK had the 2nd best performing stock market in the developed world last year

Before we try and predict where markets might go in 2017, maybe it is worth checking what we have said in the past, lest Michael Gove's observation be forgotten that "people in this country have had enough of experts".
In January we revealed that there was no secret answer to investing and no free lunches yet many so-called 'smoothed funds' almost seemed to promise this whilst concealing how they achieve their returns let alone the underlying costs. We strongly suspect that a few funds were teetering on the brink at the time and it was pure luck that saved them: we still think that investors should steer well clear. We ended the monthly commentary with a remark on the dreadful start to the year, which coincided with the oil price down by almost 70% in the preceding 12 months, saying that 'the mood across the markets is overly gloomy and … overlooked the steady economic growth rates in the developed world'. We also noted that since the pound had fallen 5% since mid-November, this should be good for UK stocks. Investors should sit tight.

By late February the rout was over and share prices were recovering quickly, but there remained considerable debate about the pros and cons of a low oil price. We argued strongly that it was a positive factor for the global economy due to its tax-like properties. In the event, the oil price rallied and so did financial markets, in which case our logic maybe proved awry. However, we were absolutely correct to reject the premise that a low oil price was a signal of impending recession. Instead it actually reflected a global supply glut and this was misread by countless 'experts'.

We ended the February note saying that 'there are always reasons to be worried about the world's economic outlook, but a falling oil price shouldn't be one of them.' In the March edition we then went straight into the one issue that did worry us – negative interest rates. The worry was essentially that central bankers and Janet Yellen in particular might make a U-turn and cut rates (rather than raising them) and go below zero. This was a genuine concern because other banks had done so before. For us, it was the fear of the unknown, because the consequences were so difficult to predict. Nevertheless, we held the faith that, once again, fears were overblown and that rates would at least be held steady.

Keeping plenty of exposure to overseas assets was possibly our most important call of 2016

By the end of March, with over two and a half months until voting day, Brexit fever was building and we felt the need to reassess strategy. Though we found it difficult to be so bold as to disagree with the bookies' odds-on prediction of *Remain* winning, given the outcome of the Scottish referendum, we stated that in terms of economic growth "the net effect whether the UK stays or goes will be minimal". We went on to say that sterling could move and "the case for a rally feels difficult to make … bringing this all together our strategy is to keep plenty of exposure to overseas assets,"

As we got closer to the vote, evidence was building that a *Leave* victory couldn't be ruled out and we reiterated our view, suggesting that building a small cash position was no bad idea, which could be used in the event of a sell-off which should be short-lived – and so it proved.

In June we compared the world to that in the topsy-turvy *Alice in Wonderland* story. *Leave* won despite *Remain* being 7-1 *on* to win just hours before the result, the 'bloodbath on the financial markets' led to the footsie being up by over 4% on the month … and Iceland knocked England out of the European Championship, although maybe that isn't such a great example. However, one thing that did happen in line with expectations was that the pound slumped and as a result the share price of companies, heavy with US assets such as Unilever, Glaxo and Diageo started to surge. One of the other consequences was that investment trust discounts suddenly widened to unusually high levels; we saw this as an over-reaction and an opportunity. We listed the top 21 trusts that struck us as being good value and the results have been excellent. Only one fund has seen its discount widen further (Henderson Opportunities Trust) but all have given positive returns averaging 17.8%. Ten of the list were up by more than 20% and the best was Polar Capital Technology with a whopping 42% return. The full table with results can be seen here.

The average return on our 21 trust picks was 17.8% since June

In July we looked at the fourteen stages of investor emotion, in relation to global equities. We are certainly on the upswing in the cycle right now and since then we may well have moved up a notch from relief to optimism. Expect us to come back to this subject a lot in 2017. In August we mooted that the weak pound was making some UK companies prime takeover candidates to US predators and named Smith Nephew and ITV amongst others that we thought looked vulnerable.

One of our favourite pastimes is looking for scare stories in the media that are long on rhetoric and short on substance. The Daily Express provides frequent examples but the serious financial press and TV is often guilty too. As we discussed the prospects of a Trump victory towards the end of the year we were reluctant to heed the countless warnings of what would happen suggesting that ahead of the vote it felt 'dangerous to hold a high cash position, because the relief rally could be meaningful,' and so it proved.

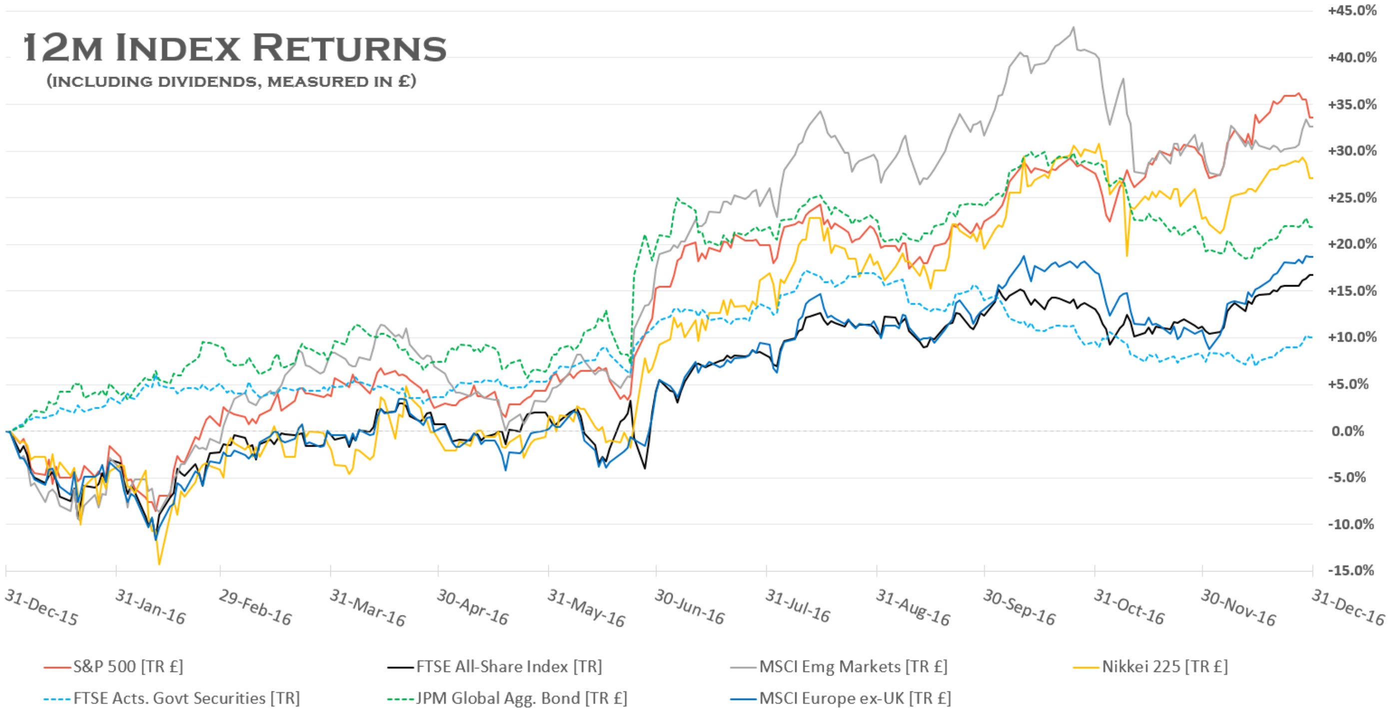
So at the risk of being self-congratulatory, we can look back on 2016 content that we made some good calls. Even when sentiment was weak, share prices were falling and other investors were losing their heads, we had a fairly clear vision and acted with conviction. The problem now is that US economic and foreign policy is critical to how events play out and we do not really know what the Trump administration will look like, let alone what direction it will take.

Which makes it far more difficult to have the same level of optimism now and there is a much greater sense of trepidation as we look into 2017. Trump is running a government by Twitter and we can only speculate as to what might happen; for this reason we will release a more detailed report following the inauguration. But from an emotional perspective, it still feels as though we are a long way from the top of the cycle. Signals of market peaks include euphoria and greed (we don't sense it), rampant merger activity (2016 saw a lower value of deals than 2015), banks acquiring banks (only 15 in Europe last year, the lowest for 5 years) and overblown property valuations (yields are still around 5% higher than base rates unlike in 2008 when they were equal). Without wishing to seem complacent, we are enjoying the ride and don't feel the need to get off just yet.

There is a sense of trepidation as we look into 2017

INDEX RETURNS

Index	Region/Asset Class	31-Dec-16	Monthly Change	1 Yr Change	2 Yr Change
UK 100	UK	7,142.83	+5.3%	+14.4%	+8.8%
UK Mid Cap	UK	518.85	+4.1%	+3.4%	+9.2%
UK Small Cap	UK	5,143.22	+4.5%	+11.0%	+17.8%
Dow Jones Ind Avg	USA	19,762.60	+3.3%	+13.4%	+10.9%
S&P 500 Index	USA	2,238.83	+1.8%	+9.5%	+8.7%
NASDAQ Comp.	USA	5,383.12	+1.1%	+7.5%	+13.7%
Nikkei 225	Japan	19,114.37	+4.4%	+0.4%	+9.5%
Euro Stoxx 50	Europe	3,290.52	+7.8%	+0.7%	+4.6%
CAC 40 Index	France	4,862.31	+6.2%	+4.9%	+13.8%
DAX Index	Germany	11,481.06	+7.9%	+6.9%	+17.1%
Milan Index	Italy	19,234.58	+13.6%	-10.2%	+1.2%
MSCI Emg Mkts (£)	Emg Mkts	459.20	+1.3%	+32.6%	+19.4%
IBOVESPA Index	Brazil	60,227.29	-2.7%	+38.9%	+20.4%
MICEX Index	Russia	2,232.72	+6.1%	+26.8%	+59.9%
S&P BSE SENSEX	India	26,626.46	-0.1%	+1.9%	-3.2%
Shanghai SE Comp.	China	3,103.64	-4.5%	-12.3%	-4.1%
Hang Seng	Hong Kong	22,000.56	-3.5%	+0.4%	-6.8%
Conventional Gilts	UK Gilts	3,524.60	+1.8%	+10.1%	+10.7%
JPM Glob Agg. Bond (£)	Global Bonds	812.64	+0.8%	+21.9%	+25.4%
WTI Crude	Oil	53.72	+8.7%	+45.0%	+0.8%
Gold Spot $/Oz	Commodities	1,152.27	-1.8%	+8.6%	-2.8%
£1 = US$	Currencies	1.23	-1.3%	-16.3%	-20.8%
£1 = €	Currencies	1.17	-0.7%	-13.6%	-8.9%
£1 = Yen	Currencies	144.50	+0.9%	-18.4%	-22.6%



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ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

WWW.ALBERTESHARP.COM

7 Elm Court
Arden Street
Stratford Upon Avon
Warwickshire
CV37 7LN
☎ 01789 404000

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