ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

September 2016

Currency Matters

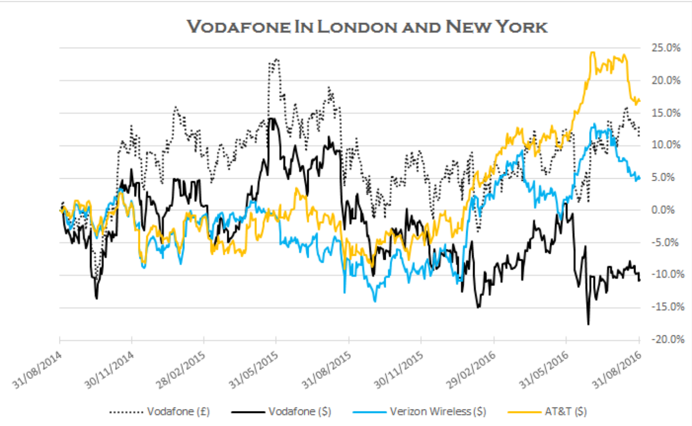
August was another positive, if relatively uneventful month across the world's financial markets. Equities and bonds edged higher as prospects for a September interest rate rise in the US seemed to dissipate due to weaker than expected economic data.

The course of US rates is likely to be *the* key market driver over the next few years, more important than the oil price, Donald Trump or Brexit. In truth, the issues are linked in that UK trade policy could potentially influence Janet Yellen's thinking to some degree. The point is that if rates move up higher and faster than is currently expected, given the unfamiliar, post-quantitative easing world, the consequences could be worse than policymakers intend.

One major factor to also consider is how this impacts currency markets. Ultimately, according to the laws of interest rate parity, countries with higher expected future interest rates will tend to see their currency appreciate as they attract money in, from investors looking to earn the relatively more attractive deposit rates.

Anticipating this correctly is potentially a very lucrative exercise, but also notoriously difficult. Suggestions of imminent hikes have been scotched countless times over the last few years, and such Fed-watching has arguably been a waste of time. In the UK, in the short-term at least, there is no chance of a rate increase due to Brexit and Mark Carney's language remains decidedly dovish. Partly as a result, sterling now stands at its most shorted level ever. In other words, the combined value of financial derivatives that are 'betting' on the pound falling further against the US dollar are at the largest levels of all time. The consensus has never been so strong.

And as long as sterling remains weak, our companies look cheap to overseas investors. For example, a recent article in Barron's magazine, (the US broadsheet equivalent of Investor's Chronicle) sung the praises of Vodafone. They highlighted an attractive 5.3% yield, bid potential and an improving financial outlook and we would agree with all of these points. Where our analysis differs is that we would look at the metrics related to the ordinary shares traded on the London Stock Exchange, the article naturally refers to the ADRs (American depository receipts), traded on the New York Stock Exchange. The value is directly linked to the underlying UK parent's shares and it is possible to exchange one ADR for ten shares in London, though few if any actually do so . The attraction of ADRs is that they are cheap, liquid and priced in dollars. This creates something of an illusion when one looks at the chart, shown below.



Source: Bloomberg

The chart shows the dollar value of Vodafone ADRs (black line) as compared to Verizon Wireless in blue and AT&T in yellow. According to this, Vodafone has underperformed the other two quite markedly over the last two years: 15% behind Verizon and almost 28% behind AT&T. However, the London listing that really matters (dotted line) shows that Vodafone has actually performed somewhere in between. Nevertheless, Barron's urges investors to buy Vodafone partly because it has 'badly trailed' their US rivals, noting that the ADRs are down 14% over the last year, not spotting the fact that sterling is down by the exact same amount.

Is it therefore coincidence that in June, US money managers were amongst the largest net buyers of shares in UK companies? According to research by NASDAQ, fund groups such as Franklin Templeton and Capital Group were large buyers before and after the vote, in contrast to UK-based Henderson and Artemis who did the opposite. It is striking that these American fund managers have a culture of value investing and the referendum result seemed to create lots of opportunity for this type of investor. Indeed, the battle between growth and value has been an interesting one over the last 12 months, but that is a story for another day.

As it stands, a weaker pound has proved supportive for UK equities, so what if it reverses? On the face of it, probably not great news, not least because it would also erode the value of our overseas holdings, but what it might do is prompt takeover activity. If there is a sense that sterling is set to rally to a higher trading range, back around the $1.50 level, US companies sizing up UK prey could be forced to move in the belief that if they wait any longer, any deal will become too expensive.

There is a long list of potential targets and we conclude by highlighting five to watch.

Smith & Nephew has been touted as a prime candidate for years, but as the pound slumps, its days could be numbered. With a strong position in joint replacement and related products such as the Birmingham hip, the captive market is growing steadily due to ageing populations. Johnson & Johnson, Stryker and even private equity could be buyers.

ITV is a rare independent media asset in a rapidly consolidating sector. With the attraction of a content library packed with international hits such as Downton Abbey and Poirot, suitors could include Comcast and Liberty Media.

Nearly all of the UK drug companies look vulnerable, especially Glaxo and Dechra but **Shire Pharmaceuticals** is the main target in our opinion and AbbVie could return after walking away in 2014.

Imperial Brands looks ripe to be taken out and talk that Philip Morris International have been at the centre of a three-way deal with BAT and Japan Tobacco seems convincing.

Britvic has a range of attractive brands with global reach, but could benefit from the distribution of a bigger player such as CocaCola or Pepsi.

INDEX RETURNS

Index	Region/Asset Class	31st Aug 2016	Monthly Change	1 Year Change	2 Year Change
UK 100	UK	6,781.51	+0.8%	+8.5%	-0.6%
UK Mid Cap	UK	523.26	+1.8%	+5.1%	+13.1%
UK Small Cap	UK	4,897.62	+2.6%	+6.6%	+9.6%
Dow Jones Ind Avg	USA	18,400.88	-0.2%	+11.3%	+7.6%
S&P 500 Index	USA	2,170.95	-0.1%	+10.1%	+8.4%
NASDAQ Comp.	USA	5,213.22	+1.0%	+9.1%	+13.8%
Nikkei 225	Japan	16,887.40	+1.9%	-10.6%	+9.5%
Euro Stoxx 50	Europe	3,023.13	+1.1%	-7.5%	-4.7%
CAC 40 Index	France	4,438.22	-0.0%	-4.6%	+1.3%
DAX Index	Germany	10,592.69	+2.5%	+3.2%	+11.9%
Milan Index	Italy	16,943.38	+0.6%	-22.8%	-17.1%
MSCI Emg Mkts (£)	Emg Mkts	446.32	+3.9%	+31.3%	+9.3%
IBOVESPA Index	Brazil	57,901.11	+1.0%	+24.2%	-5.5%
MICEX Index	Russia	1,971.59	+1.4%	+13.8%	+40.8%
S&P BSE SENSEX	India	28,452.17	+1.4%	+8.3%	+6.8%
Shanghai SE Comp.	China	3,085.49	+3.6%	-3.8%	+39.2%
Hang Seng	Hong Kong	22,976.88	+5.0%	+6.0%	-7.1%
Conventional Gilts	UK Gilts	3,735.49	+2.7%	+16.7%	+24.0%
JPM Glob Agg. Bond (£)	Global Bonds	817.07	+0.9%	+27.5%	+30.1%
WTI Crude	Oil	44.70	+7.5%	-9.1%	-53.4%
Gold Spot $/Oz	Commodities	1,308.97	-3.1%	+15.3%	+1.6%
£1 = US$	Currencies	1.31	-0.7%	-14.4%	-20.8%
£1 = €	Currencies	1.18	-0.6%	-14.0%	-6.8%
£1 = Yen	Currencies	135.89	+0.7%	-26.9%	-21.3%

ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

WWW.ALBERTESHARP.COM

7 ELM COURT
ARDEN STREET
STRATFORD UPON AVON
WARWICKSHIRE
CV37 7LN

☎ 01789 404000