IMPERIUM CAPITAL

momentum

www.imperium-capital.biz | Vol. 131 | October 2017

VIEWPOINT

Newsflash

A new month and the 131st issue of Viewpoint from **Imperium Capital**.

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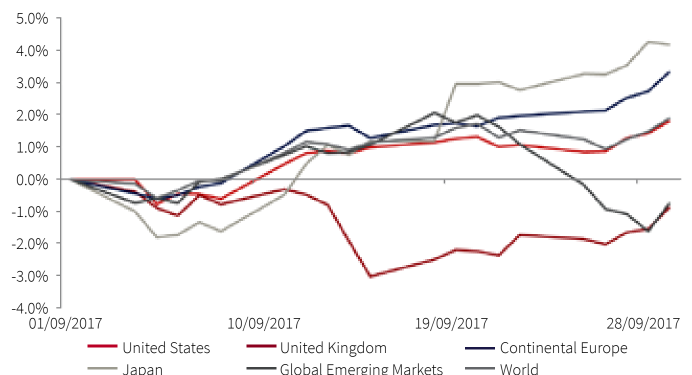
Market Commentary

During September the global economy continued to be supportive for risk assets, with global equities performing strong. Government bonds retreated in light of the more risk-on environment, whilst the US Dollar strengthened towards the end of the period, a contrast to its large year-to-date falls.

During the quarter developed equity markets returned 2.2% with almost every major region partaking in the rise. Within developed markets, Japan posted the strongest returns in local currency terms advancing 4.3%, followed by Continental Europe with a 3.9% gain. Emerging markets posted returns of -0.4%, the first negative month since November 2016.

Figure 1: Major Equity indices returns



Global government bonds retreated -1.1%, whilst global bonds fell -0.8% as investors' risk appetite returned. UK government bonds sold off heavily during the month, ending 2.7% down after particularly hawkish rhetoric by the Bank of England, suggesting a rate rise before year-end. Sterling notably appreciated versus the US Dollar, rising 3.7%, partially contributing to the 0.8% fall in UK equities. In commodities the most notable move was in oil with Brent crude rising 9.9%, reversing sharp year-to-date losses. This price reversal follows an apparent peak in supply surpluses combined with rising demand forecasts.

Figure 2: Brent crude climbs during September

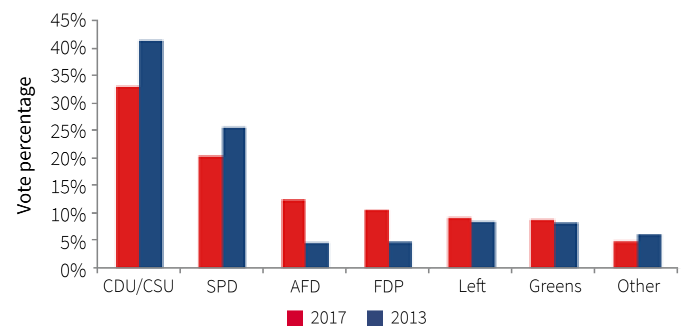
The key factor supporting markets so far this year has been the improvement in economic growth globally, forming the first synchronised recovery since the financial crisis. In the past three months the economic recovery has strengthened, particularly in Europe where growth forecasts have been continually upgraded in light of strong economic data. The US economy also appears promising with growth accelerating and business investment rising. Forward indicators including purchasing managers' indices demonstrate the US is on course to maintain its 2.0-2.5% growth rate next year. The uptick in global growth has boosted corporate profits, up over 10% in the US this year, and benefitted emerging markets, led by China.

Year-to-date central banks have maintained exceptionally loose monetary policy, supported by low inflation, a sustainable global economic recovery and few signs of credit fuelled booms. This has proved highly favourable for risk assets; however during September, the rhetoric of central banks transitioned to a more hawkish stance. The Bank of England, European Central Bank and Federal Reserve all indicated that a tightening of policy was likely in the next few months. The Federal Reserve outlined plans to reduce its balance sheet, including reducing bond buy-backs by USD 10 billion a month, eventually rising to USD 50 billion. Following from the Federal Reserve, the European Central Bank has indicated it will announce plans to reduce its balance sheet, although, unlike the Federal Reserve, this is unlikely to be in conjunction with rate rises. The Bank of England became notably more hawkish, and is expected to increase the base rate before year-end. However, given the uncertainties surrounding parliament and Brexit clouding the UK economy, further policy tightening appears far less likely than the European Central Bank and the Federal Reserve. In contrast, the Bank of Japan is expected to maintain ultra-loose policy for the foreseeable future with inflation persistently below 1% whilst target inflation remains at 2%.

These changes represent the first significant withdrawal of liquidity from markets since the financial crisis. Yields on 2 year Treasuries have already risen to 1.5%, double its yield a year ago and the highest since 2008. The net effect of the slow unwinding of quantitative easing will be that central bank asset purchases fall from a five year average of USD 120 billion per month to roughly USD 20 billion by 2019, with only the Bank of Japan continuing current purchasing rates. The effect this change has on markets will be a critical test for policy makers and investors.

While politics continued to dominate headline news, the effect on markets was limited and no single event or series of events was able to derail the bullish environment driven by economic fundamentals. In the US, confidence in President Trump's ability to pass his policy initiatives in congress was fading, however, an announcement on tax reforms helped restore faith. Reforms include large cuts to corporate taxes, cuts to personal taxes and a simplification of personal tax brackets. In Europe, the positive sentiment and confidence in EU unity following past elections took a hit after a disappointing election result for Angela Merkel in the German elections. Her party's share fell from 42% in the previous election to 33% with the far-right Alternative for Germany (AfD) gaining hugely, polling 13% and acquiring its first seats in the Bundestag since WWII. With the far right and far left polling 22%, it appears the forces of populism remain strong. Whilst Merkel will remain as Chancellor, she has greatly weakened authority and has the task of forming a coalition. This election result will reduce her ability to push forward major reforms and diminishes the likelihood of further EU integration. The recent Catalonian independence saga further highlights the lingering forces of populism within the EU.

Figure 3: German Federal Election results; 2017 vs 2013



Sources: Federal Returning Officer, Bloomberg, The Economist

In the UK uncertainties remain rife with Brexit negotiations hampered by ongoing political disorder as Prime Minister Theresa May appears to be falling in popularity with diminishing authority. Such uncertainties threaten the UK's ability to reach a satisfactory agreement with the EU before it exits in March 2019. Amidst this backdrop UK assets underperformed in September, although Sterling rallied following the increasingly hawkish rhetoric from the Bank of England.

In Asia, politics have been dominated by North Korea's accelerating nuclear ambitions, particularly following the recent hydrogen bomb test. Despite high US and North Korea tensions, investors have made the assumption that full-scale nuclear war is far too catastrophic to be a feasible option for either party. More likely, North Korea will become a fully-fledged nuclear power, leading to policies of containment. In Japan, Prime Minister Shinzo Abe called a snap election, taking advantage of his rise in poll ratings. He is likely to return to power and continue his bold policies of monetary and fiscal economic support in conjunction with structural reforms.

While geopolitics caused occasional small market shocks, the broad environment remains favourable for risk assets. The global economic expansion of present appears sustainable with few signs of excess credit and inflation remaining subdued. Although geopolitics remains a threat to market stability, thus far economic fundamentals have outweighed the political risks with the longer term outlook for markets appearing favourable.

However, there are shorter term risks ahead. Most significant is the transition to monetary policy normalisation by major central banks, involving an unwinding of quantitative easing and interest rate rises. This is likely to be a key determinant of short term market moves; too much tightening could cut short the economic expansion and threaten markets, too little could invoke high levels of inflation caused by excess liquidity. In addition, over the last twelve months share price growth has outstripped earnings growth, leaving valuations of most equity markets at high levels. As the global economy strengthens, there is a risk of underestimating the rise in inflation as excess capacity is utilised. This combination of factors leaves markets vulnerable to a correction.

While recognising these shorter term risks, we believe that the ultimate driver of markets will be the fundamentals for the global economy. The economic recovery generally is broadening on what appears to be a sustainable basis, and tightening of monetary policy from current very loose levels will be gradual. Inflationary forces globally are held back by structural issues, including globalisation, the rise of the digital economy and still high debt levels. To date, the tightening moves we have seen have not been a hurdle for markets and all central banks are adopting an extremely cautious, gradualist approach to policy changes. We therefore expect this cycle to be sustained for some considerable time ahead. Opportunities for returns outweigh the risks and we expect equities to continue to outperform bonds as the cycle progresses, so periodic bouts of weakness in markets will present buying opportunities for risk assets.

Source: Bloomberg. Returns in US dollars unless otherwise stated. September 2017.

Market Performance - Global (Local returns)

Asset Class/Region	Index	To 29 September 2017		
		Currency	1 Month	Year to date
Developed markets equities				
United States	S&P 500 NR	**USD**	2.0%	13.7%
United Kingdom	MSCI UK NR	**GBP**	-0.8%	6.5%
Continental Europe	MSCI Europe ex UK NR	**EUR**	3.9%	12.1%
Japan	Topix TR	**JPY**	4.3%	12.5%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	**USD**	-0.3%	26.9%
Global	MSCI World NR	**USD**	2.2%	16.0%
Emerging Market Equities				
Emerging Europe	MSCI EM Europe NR	**USD**	-1.4%	14.6%
Emerging Asia	MSCI EM Asia NR	**USD**	0.0%	31.8%
Emerging Latin America	MSCI EM Latin America NR	**USD**	1.6%	26.7%
BRICs	MSCI BRIC NR	**USD**	0.9%	33.0%
Global emerging markets	MSCI EM (Emerging Markets) NR	**USD**	-0.4%	27.8%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	-0.9%	2.4%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	**USD**	-0.7%	1.9%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	-0.2%	5.2%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	0.9%	7.0%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	**GBP**	-2.7%	-0.1%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	**GBP**	-1.8%	2.4%
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	-0.5%	-0.4%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	-0.2%	1.8%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	**EUR**	0.6%	6.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	**JPY**	-0.4%	-0.2%
Australian Government	JP Morgan Australia GBI TR	**AUD**	-0.5%	1.9%
Global Government Bonds	JP Morgan Global GBI	**USD**	-1.1%	5.8%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**USD**	-0.8%	6.3%
Global Convertible Bonds	UBS Global Focus Convertible Bond	**USD**	0.5%	9.2%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	**USD**	-0.1%	8.6%

Source: Bloomberg *[e] denotes estimate*

Market Performance - Global (Local returns)

Asset Class/Region	Index	To 29 September 2017		
		Currency	1 Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	**USD**	-0.3%	2.7%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	**AUD**	0.5%	-5.3%
Asia Property Securities	S&P Asia Property 40 Index NR	**USD**	-0.5%	21.4%
Global Property Securities	S&P Global Property USD TR	**USD**	0.4%	11.9%
Currencies				
Euro		**USD**	-0.8%	12.3%
UK Pound Sterling		**USD**	3.7%	8.5%
Japanese Yen		**USD**	-2.3%	4.0%
Australian Dollar		**USD**	-1.4%	8.9%
South African Rand		**USD**	-4.0%	1.0%
Commodities & Alternatives				
Commodities	RICI TR	**USD**	1.5%	-1.4%
Agricultural Commodities	RICI Agriculture TR	**USD**	-0.1%	-3.7%
Oil	Brent Crude Oil	**USD**	9.9%	1.3%
Gold	Gold Spot	**USD**	-3.1%	11.1%
Hedge funds	HFRX Global Hedge Fund	**USD**	0.5%*	4.3%*
Interest rates				
United States			1.25%	
United Kingdom			0.25%	
Eurozone			0.00%	
Japan			0.10%	
Australia			1.50%	
South Africa			6.75%	

Source: Bloomberg [e] *denotes estimate*

Market Performance - UK (All returns in GBP)

Asset Class/Region	Index	To 31 August 2017		
		Currency	1 Month	Year to date
Developed markets equities				
UK - All Cap	MSCI UK NR	**GBP**	-0.8%	6.5%
UK - Large Cap	MSCI UK Large Cap NR	**GBP**	-0.8%	5.7%
UK - Mid Cap	MSCI UK Mid Cap NR	**GBP**	-0.9%	6.6%
UK - Small Cap	MSCI Small Cap NR	**GBP**	0.9%	14.4%
United States	S&P 500 NR	**USD**	-1.8%	4.8%
Continental Europe	MSCI Europe ex UK NR	**EUR**	-0.7%	15.7%
Japan	Topix TR	**JPY**	-1.8%	7.3%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	**USD**	-4.0%	17.0%
Global developed markets	MSCI World NR	**GBP**	-1.6%	6.9%
Global emerging markets	MSCI EM (Emerging Markets) NR	**GBP**	-4.1%	17.8%
Bonds				
Gilts - All	BofA Merrill Lynch Gilts TR	**GBP**	-2.7%	-0.1%
Gilts - Under 5 years	BofA Merrill Lynch Gilts TR under 5 years	**GBP**	-0.8%	-0.4%
Gilts - 5 to 15 years	BofA Merrill Lynch Gilts TR 5 to 15 years	**GBP**	-2.4%	0.3%
Gilts - Over 15 years	BofA Merrill Lynch Gilts TR over 15 years	**GBP**	-4.0%	-0.2%
Index Linked Gilts - All	BofA Merrill Lynch Inflation-Linked Gilts TR	**GBP**	-4.1%	-1.2%
Index Linked Gilts - 5 to 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR 5 to 15 years	**GBP**	-2.1%	0.0%
Index Linked Gilts - Over 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR over 15 years	**GBP**	-5.0%	-1.8%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	**GBP**	-1.8%	2.4%
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	-4.6%	-5.7%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	-3.9%	-3.1%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	-2.9%	-1.4%
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	-4.8%	2.7%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	-4.6%	5.0%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	**EUR**	-3.8%	9.4%
Global Government Bonds	JP Morgan Global GBI	**GBP**	-4.8%	-2.5%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**GBP**	-4.5%	-2.0%
Global Convertible Bonds	UBS Global Focus Convertible Bond	**GBP**	-3.3%	0.7%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	**GBP**	-3.8%	0.1%

Source: Bloomberg *[e] denotes estimate*

Market Performance - UK (All returns in GBP)

Asset Class/Region	Index	To 31 August 2017		
		Currency	1 Month	Year to date
Property				
UK Direct Property	UK IPD All Property TR	**GBP**	0.0%*	6.5%*
Global Property Securities	S&P Global Property USD TR	**GBP**	-3.4%	3.1%
Currencies				
Euro		**GBP**	-4.3%	3.3%
US Dollar		**GBP**	-3.5%	-7.9%
Japanese Yen		**GBP**	-5.8%	-4.2%
Commodities & Alternatives				
Commodities	RICI TR	**GBP**	-2.3%	-9.2%
Agricultural Commodities	RICI Agriculture TR	**GBP**	-3.8%	-11.3%
Oil	Brent Crude Oil	**GBP**	5.7%	-6.7%
Gold	Gold Spot	**GBP**	-6.7%	2.4%
Interest rates				
United Kingdom			0.25%	
United States			1.25%	
Eurozone			0.00%	
Japan			0.10%	

Source: Bloomberg [e] *estimate*

Asset Allocation Dashboard

Positive (green) · Neutral (yellow) · Negative (red)

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Neutral
European equities (relative to developed)	Neutral
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Positive
Emerging market equities	Positive
Fixed Income	
Government	Neutral
Index-linked (relative to government)	Neutral
Investment grade (relative to government)	Neutral
High yield	Neutral
Loans	Neutral
Emerging market debt	Neutral
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Property (UK)	Neutral
Currencies	
GBP	Neutral
Euro	Neutral
Yen	Neutral

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