Weekly Digest

Week ending **18 June 2017**

Coco pops

It was the summer of 2007 when one of the first canaries in the global financial coalmine started chirping. Over the ensuing months the canary that was Bear Stearns fell from its perch as its hedge funds failed and the bank came under increasing financial pressure, before being sold to JP Morgan at a fire sale price. Thankfully for the bondholders the new owner took on the debt obligations of the failed bank, a pattern that repeated through the crisis with bondholders being largely spared any loss burden as losses mounted and multi-billion dollar bailouts propped up the financial system. Ten years on and there is a newer class of debt in the bank capital structure known as 'contingent capital' bonds, or 'CoCos', which were designed to add an additional loss absorbing layer to an issuer's tier one equity. They are also known as alternative tier one bonds or 'AT1s'. Usually they will have a pre-determined common equity tier one (CET1) ratio trigger level at which the bonds will convert into equity or be written down. To compensate the investor for this additional risk the bonds typically pay a high coupon and in this low yield world demand and issuance has been robust with nearly $200bn additional capital raised through these bonds.

This month we witnessed the first conversion of one of these bonds when Banco Popular, a Spanish lender, was on June 7th sold for the token price of 1 Euro to Santander. This followed liquidity concerns that led Europe's Single Resolution Board to conclude that the bank had reached the 'point of non-viability', and overnight the equity and junior debt was essentially wiped out. Investors in the AT1s might feel aggrieved as the bonds had trigger levels of around 7% and 5% whilst recently CET levels were still reported to be double digits. However, this speaks to an important point that it is the local regulator which determines viability, not the bank itself, and the axe will likely fall well before prospectus tier one trigger levels are reached. The fallout from the event was limited however, and the sector as a whole has held up well, far better than early 2016 when concerns over Deutsche Bank led the whole sector sharply lower before later recovering those losses.

This swift regulatory led action has shone the spotlight once again on European banks' huge exposure to non-performing loans (NPLs) which weigh heavily on their operations and capital ratios. The shares and subordinated debt of Liberbank, a smaller Spanish lender with significant NPL exposure, came under pressure following the sale and the Spanish regulator has since banned short selling of its shares. The fattest canary though undoubtedly chirps an Italian tune with NPLs in that country estimated to be in excess of 250bn Euros, with several Italian banks now finding themselves the unwanted centre of attention. Although fallout from the Banco Popular sale has to date been limited we are cognisant that now the regulator's weapon has been fired to seemingly good effect, they will be closely watching developments elsewhere.

The portfolio managers recognise the stark asymmetry embedded in these bonds and for that reason they only have minimal exposure to the sector through a specialist active bond manager. It is not an asset class where you want a passive, index like exposure, as credit selection really is crucial in this still young and largely untested market. In these more specialised asset classes the managers prefer to use smaller, more dynamic managers, who are not forced to own sectors or issues because of their size. Indeed, the largest holder of the now worthless Banco Popular AT1 bonds was one of the best known managers on the street. Not so popular now.

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

The **Marketplace**

- UK and US inflation figures miss expectations
- Federal Reserve increases Funds rate
- US economic data softer than expected
- Bank of England votes 5-3 to hold the base rate
- French party En Marche! secure convincing parliamentary majority

Market **Focus**

US

- As expected, the Federal Reserve raised the Federal funds rate by 25 basis points, increasing the target range to 1-1.25%. The Federal Reserve dot plot indicated that Federal Open Market Committee (FOMC) members expect one further rate rise this year, in line with market expectations prior to the meeting.
- US year on year CPI inflation missed forecasts of 2.0%, with the annual rate now at 1.9%, pushed down by month on month inflation in May at -0.1%. Following this data, 10-year Treasury yields fell as much as 11 basis points hitting intraday lows of 2.1%, whilst the US dollar sold off up to c. 0.8%. Despite this, the US Dollar Index only fell c. 0.2% during the week.
- Softer than expected US month on month economic data included US headline retail sales unexpectedly falling 0.3%, industrial production flat lining, and housing starts declining 5.5%.
- US tech stocks continued to struggle with the NASDAQ falling five times in the last six sessions. Food retail stocks across the US and Europe also broadly fell following the announcement of Amazon's USD 14 billion bid for Whole Foods, sparking fears of a new, large competitor.
- Both the Dow Jones and the S&P 500 rose during the week, posting c. 0.5% and 0.1% increases respectively.

UK

- Fears of a squeeze on UK living standards increased as year on year CPI inflation for May overshot expectations with a figure of 2.9% versus expectations of 2.7%. Weaker than expected wage growth of 2.1% (versus 2.4% expected) confirmed fears that UK real incomes have begun to fall.
- On Thursday, the Bank of England's Monetary Policy Committee (MPC) held the base rate at 0.25%, voting 5-3. The more marginal voting split highlights the increasingly hawkish stance of the MPC; raising the prospects for a future rate rise.
- UK Gilts were particularly volatile during the week with 10-Year Gilts initially rising 5 basis points following the CPI inflation data, only to fall 10 basis points with weaker than expected wage growth data. Finally, in response to the MPC meeting, Gilts rose 10.6 basis points with the prospects of a rate hike increasing.
- UK retail sales (including fuel) fell by 1.2% versus expectations of 0.8%
- UK equities fell 0.8% over the week.

Europe

- In the second round of French parliamentary elections on Sunday, President Macron's party En Marche! secured a convincing majority, winning 350 out of 577 seats, although this was slightly short of expectations.
- Greece and its creditors reached a deal outlining the next stages of its bailout plans. Creditors approved a disbursement of EUR 8.5 billion; however the agreement did not include cuts to Greece's debt load.
- Despite the lessening of political and economic uncertainty within France and Greece, Continental European equities ended 0.4% down for the week.

Alex Harvey (CFA) & Oliver Cooper

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 June 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.1%	1.0%	9.4%	18.8%
United Kingdom	GBP	-0.8%	-0.6%	6.8%	30.4%
Continental Europe	EUR	-0.4%	0.2%	11.3%	27.2%
Japan	JPY	0.3%	1.8%	6.2%	31.4%
Asia Pacific (ex Japan)	USD	-0.6%	0.9%	18.7%	28.6%
Australia	AUD	1.7%	0.9%	3.9%	17.1%
Global	USD	0.1%	0.7%	11.0%	20.5%
Emerging Market Equities					
Emerging Europe	USD	-1.8%	-1.9%	2.3%	21.3%
Emerging Asia	USD	-1.5%	0.4%	21.5%	30.9%
Emerging Latin America	USD	-0.1%	0.1%	9.5%	25.3%
BRICs	USD	-1.9%	-0.5%	15.5%	30.7%
MENA countries	USD	-0.2%	-0.7%	0.3%	9.5%
South Africa	USD	-3.0%	-3.1%	8.7%	20.4%
India	USD	-0.9%	0.0%	24.2%	24.5%
Global Emerging Markets	USD	-1.4%	-0.1%	17.2%	28.3%
Bonds					
US Treasuries	USD	0.3%	0.4%	2.5%	-1.5%
US Treasuries (inflation protected)	USD	-0.5%	-0.7%	1.2%	0.4%
US Corporate (investment grade)	USD	0.5%	0.6%	4.1%	3.3%
US High Yield	USD	0.1%	0.2%	5.0%	13.8%
UK Gilts	GBP	-0.3%	-0.3%	2.1%	3.2%
UK Corporate (investment grade)	GBP	0.0%	0.2%	3.6%	7.3%
Euro Government Bonds	EUR	0.2%	0.5%	0.1%	-0.7%
Euro Corporate (investment grade)	EUR	0.0%	0.1%	1.3%	2.3%
Euro High Yield	EUR	0.3%	0.4%	4.3%	9.9%
Japanese Government	JPY	0.1%	0.0%	-0.1%	-3.7%
Australian Government	AUD	0.0%	-0.1%	3.5%	0.3%
Global Government Bonds	USD	0.3%	0.1%	4.5%	-3.3%
Global Bonds	USD	0.3%	0.1%	4.5%	-1.1%
Global Convertible Bonds	USD	-0.5%	-0.1%	7.2%	8.2%
Emerging Market Bonds	USD	0.0%	0.5%	7.2%	7.9%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 June 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	1.4%	3.2%	3.3%	2.3%
Australian Property Securities	AUD	4.3%	2.7%	3.0%	-0.6%
Asia Property Securities	USD	-0.5%	1.6%	18.1%	22.1%
Global Property Securities	USD	1.1%	2.6%	9.6%	9.4%
Currencies					
Euro	USD	-0.1%	-0.4%	6.4%	-0.3%
UK Pound Sterling	USD	0.4%	-0.8%	3.5%	-10.0%
Japanese Yen	USD	-0.3%	-0.1%	5.6%	-5.9%
Australian Dollar	USD	1.2%	2.5%	5.9%	3.6%
South African Rand	USD	0.3%	2.7%	6.8%	19.8%
Swiss Franc	USD	-0.5%	-0.6%	4.6%	-1.0%
Chinese Yuan	USD	-0.1%	0.3%	2.2%	-3.1%
Commodities & Alternatives					
Commodities	USD	-0.9%	-2.3%	-7.6%	-3.9%
Agricultural Commodities	USD	0.4%	2.0%	0.1%	-6.0%
Oil	USD	-1.6%	-5.8%	-16.6%	0.4%
Gold	USD	-1.0%	-1.2%	8.9%	-1.9%
Hedge funds	USD	-0.2%	0.0%	2.4%	6.1%

Source: Bloomberg

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