30 September 2016

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INVESTMENT MANAGEMENT

WEEKLY INVESTMENT UPDATE

Deutsche Bank raises Systemic Fears

KEY MESSAGES:

The major risks that are marked in the coming quarter are the US presidential elections, OPEC's meeting and a likely increase in interest rates from the Federal reserve.

Low interest rates remain a headwind for the banking sector especially in the European markets with Deutsche Bank shares at a multi-decade low.

Risk of contagion and systemic risks if Deutsche Bank collapses are significant. It's collapse could require the German Government to act to avoid systemic risk.

Crude oil gained by 6% after OPEC agreed to cut the output.

Our Safety First Approach

The Safety First investment process demands disciplined asset allocation to ensure that the volatility caps in our portfolios are not exceeded. The volatility caps are clearly communicated to our vulnerable investors and act as a safeguard against risk, delivering peace of mind. In client discussions we find most investors are concerned, perhaps more than ever, about the economic and political backdrop to their investment portfolios.

Considering equity exposure, our current weightings are well below that of standard industry benchmarks which are not tasked with maintaining a risk cap for investors. The Safety First equity weightings include low volatility, low cost exposure to defensive US equity and actively managed infrastructure funds which offer generous income and inflation linked returns.

In recent months our allocations have delivered exactly what was required during an uncertain period for investors and we are pleased to see that we have delivered strong performance well within the volatility caps imposed on our investment process. The level of volatility across the Safety First portfolios currently ranges between 1.55 - 5.12, well below that of benchmark indices which offer standard, less active tactical asset allocation.

Market developments during the week

OPEC agreed to cut oil production to between 32.5m – 33m barrels a day for the first time in eight years. This decision has driven oil prices sharply higher, on Thursday, Brent crude climbed 6% to $48.85 per barrel. How the proposed reduction should be shared out between member countries will be decided in the next OPEC meeting in November.

On Thursday, following the Bloomberg report that about 10 hedge funds, including Millennium Partners, Capula Investment Management and Rokos Capital Management, had moved part of their business with Deutsche Bank over concerns of DOJ's high initial claim, the bank's US-listed shares were down by 6.7%; given a market cap of $15.8bn, the S&P 500 Index slid 0.9% and the Dow Jones Industrial Average declined by 1.1%. On Friday Deutsche Bank's share price opened with a drop of 9%, pushing the shares below €10, its lowest since 1983. Deutsche Bank's significance to the European banking model cannot be overstated. Its fall from grace could represent a Lehman movement.

This would represent a sudden stop to the global economy being a simultaneous collapse in trade, investment and consumption, caused through the worry of counterparty risk and loss of trust in financial institutions, with credit to borrowers quickly drying up.

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Unlike Lehman however, Deutsche has access to emergency funding from the ECB and potential intervention from the German Government. Further, the environment is different to that of 2008 as Deutsche Bank's troubles appear to be confined to single institution rather than a growing issue throughout the global financial system. This gives Deutsche Bank the lifeline, albeit unattractive to both management and investors, to generating capital through asset disposals or a potential rights issue.

Should Deutsche Bank's trouble continue this could have a systemic effect, with some of the European banks remaining fragile. The issues facing Deutsche Bank' deal another blow to the damaged reputation of the banking system, encouraging politicians to make statements that could undermine the trust in the financial intermediation process, renewing concerns over the growth prospects of the European banks. There is an expectation that the European financial institutions will become more prudent - placing balance sheet robustness ahead of extending credit to SMEs, a move which is not easily compensated by central bank and governments.

By highlighting the gaps in the regulatory and supervisory structure aimed at ensuring safety and soundness of the financial system, Deutsche Bank have re-focused attention to central banks and regulators. This exposes these bodies to a threat of political interference at a time when there is questioning over the ECB's use of negative policy interest rates and its balance sheet for large-scale asset purchases.

It is therefore beneficial to stabilize Deutsche Bank as the effects of doing so extend well beyond one institution. There are still sufficient tools for restoring stability such as intervention from the German Government. However, as time passes it becomes increasingly difficult for the European banking sector to contain and minimize the risk of contagion and systemic risk.

Commodities

Crude oil fell 0.7% to $47.49 a barrel in New York, after gaining more than 7% over the last two days as OPEC's agreement imposed an overall production cap.

Gold climbed by 0.4% to $1,325.45 an ounce during the week as investors spurred a selloff in equities seeking haven assets amid increased concern over Deutsche Bank.

Aluminium prices have rallied 11% this year, and zinc has surged 45%. However, China is set to increase production as smelters restart operations so the rallies may be short lived.

Bonds & Equities:

During the third quarter Germany's Dax is up by 7.5%, while Japan's Topix has risen 7.8% in spite of the performance of equity markets being more volatile in mid-September.

For the third quarter, the forward 12-month price earning of S&P 500 stood at 16.8-times which is above the 5-year average of 14.8 times, as per the FactSet valuations,

OPEC's new deal has driven energy shares into positive territory.

The U.S. 10-year Treasury yield declined two basis points to 1.54%. Yields on sovereign debt in Australia and New Zealand also dropped to three-week lows.

European government bonds have weakened due to the sharp rise in oil prices after the OPEC deal.

Germany's 10-year bund yield fell four basis points to minus 0.155% which is the lowest since July.

Japan's Nikkei 225 was down by 1.46%, while the Topix index fell 1.52%.

Australia's ASX 200 was down by 0.65% with most sectors finishing lower.

Major economies:

US core PCE hit 1.7% in August, up from 1.6% in July.

Eurozone consumer price inflation edged higher at 0.4% in September, which is the highest level in more than two years. The growth in prices is mainly due to the services sector, with inflation up 1.2%. But core inflation, in food and energy prices, remained flat at 0.8%. The unemployment rate in Eurozone has held a five-year low at 10.1%.

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Commerzbank, the second-biggest bank in Germany is planning to cut 9,600 jobs in a restructuring which will help to cut its cost base from €7bn to €6.5bn at the end of 2020. It expects to take a €700m write down as part of a strategic overhaul and suspended dividends to boost the profitability. Shares in the bank were down 0.5% at €5.97 following the above decision.

The DOJ hopes to collect multibillion dollar fines from Barclays, Credit Suisse and Deutsche Bank, before the US presidential election. Shares of Deutsche Bank fell almost 7% in New York, since the US Department of Justice demand for a high initial claim of $14 billion in fines for mis-selling mortgage securities. Later shares had steadied after agreeing to sell its U.K. insurance unit Abbey Life insurance arm for $1.2bn. We wonder how much more pain European Investments Banks can take.

Russia set a target to double the size of weekly bond auctions as much as 30 billion to 40 billion rubles per week through the end of the year which will put a cap on bond prices and could lift longer yields.

Emerging markets:

The Bloomberg Dollar Spot Index rose 0.1%. Most emerging-market currencies weakened, led by a 0.5% decline in Malaysia's ringgit.

Mexico's central bank raised borrowing costs for the third time this year by 50 basis points to 4.75%. Following the decision, the Mexican peso traded down 0.5% against the U.S. dollar at 19.4734 per dollar.

India's rupee currency weakened 0.6%, the most since June 24, to 66.8550 per dollar and bonds extended losses, after surgical terror strikes in Pakistan. BSE Sensex index was down 1.6% to a one-month low, after dropping 2% earlier. The yield on sovereign notes due September 2026 surged 8 basis points to 6.86%.

Kenya's economy grew 6.2% in the second quarter as tourism rebounded and agriculture grew at a faster pace.

UK economy:

Sterling gained 0.5% to 86.12 pence per euro as the UK economy grows by 0.7% in second quarter which beats the estimated growth of 0.6% by the Office for National Statistics. However, this is still low compared to the first quarter, when the economy grew by 0.8%. The ONS statistics show that the UK's services sector, which makes up four-fifths of the UK economy, accelerated 0.4% in July, while it grew 0.3% in May and June.

The Bank of England intends to buy £10bn of corporate bonds in its latest round of QE, aimed at boosting the private sector over the next 18 months. It states that only the debt of companies that make material contribution to UK economic will be eligible. However, foreign companies' debt including Apple and fast-food chain McDonald's is also on the list of eligible debt.

The retail sale of groceries, specialist food and drink, and footwear in UK has fallen in September, according to CBI survey. As per ONS statistics, spending in shops and online grew 1.9% in July, in spite of the Brexit referendum. The annual growth in retail sales volumes slowed from 6.2% in August to 0.5% in September, the lowest rate since the start of 2013. On the other hand, UK consumer confidence index reached its biggest monthly rise by 6 points in September as per GfK's survey. The real issue for retailers is sterling's weakness and how they will fare when their hedges run off.

According to standard & Poor's forecast, the process of exiting the EU will lead to a decrease in UK GDP growth by 2.1% between now and 2018. The Eurozone will also be affected with reducing GDP growth by 0.7 points over 2017-2018.

Ms Shafik, deputy governor of the BoE, said on Wednesday there is a need of a further cut in UK interest rates to maintain lower unemployment without generating inflation.

For now we don't see this but we live in an extremely uncertain world with sizeable global macro events and risks on the horizon. All in all, I am happy that we continue to position our Safety First portfolios defensively.

Jason Granite
Chief Investment Officer
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Frenkel Topping Investment Management's ("FTIM's") Safety First performance

	Since inception (04 Jan – 30 Sep 2016)		Since launch (29 Apr – 30 Sep 2016)	
	Performance	**FTIM Volatility***	**Performance**	**FTIM Volatility***
FTIM Safety First 1 is currently a cash product with returns in line with base rate				
FTIM Safety First 2	2.11%	1.55%	1.66%	1.41%
FTIM Safety First 3	3.35%	2.05%	2.43%	1.84%
FTIM Safety First 4	3.43%	3.19%	2.20%	1.96%
FTIM Safety First 5	4.54%	3.48%	2.61%	2.87%
FTIM Safety First 6	7.52%	5.12%	5.01%	4.89%

Date: 30 September 2016
Source: FTIM / FE Analytics
All figures are on a bid - bid, total return basis and are quoted net of underlying fund charges, our DFM fee of 0.6% including VAT and a platform fee of 0.2%. Advice charges would depend on the charges made by your independent financial adviser. The deduction of these charges would reduce the performance shown.
Actual Past Performance Data is from 29/4/16 only as the models only launched on this date and therefore 5 year performance data is not available and 12 month performance figures are not able to be shown. Pre - launch performance from 4/1/16 – 29/4/16 is Simulated Past Performance.
The figures represent performance of a model portfolio; individual account performance may differ if your account does not follow the model.
Past performance is not a reliable indicator of future performance. Investment values can go down as well as up and may be affected by exchange rate variations.

*Volatility is a measure of the movement in the price of an asset around its average return. The higher the volatility the more risk involved in the investment.