CERNO CAPITAL

Investment Letter dated 12th July 2017

The half year is over.

Global portfolios have performed well with gains across most classes of bonds and equities, amplified in the hands of dollar based investors. Dollar weakness, as it so often does, has commuted easy conditions and that has provided a window for a meaningful rally in Asian and Emerging Market assets. Over the half year, seven of the ten major global industrial sectors returned more than 10% in USD terms (Materials was just shy of 10%). Telecoms were flat. The Energy sector was the sole poor performer (-9.7%) on account of the fall in the oil price.

Translating these numbers into GBP reduces the scale of the gains. Sterling was up 5.6% against the dollar in the first half, only Technology returned over 10% in sterling terms.

June markets offered something different to the five preceding months. A correction developed in the last few days of the month. The reversion in US bond yields rippled out to a host of other asset classes. US rates of all maturities increased, a phenomenon commonly described as an upward shift in the curve.

In in past few years, we have seen this on several occasions and such reversions have always been retraced, with bond yields settling back down. Complacency is dangerous. If the US bond market were a reptile, we would describe it as a sleeping anaconda, apparently docile but possessing the ability to strangle all in its path.

Whilst the proximate event was a 0.25% increase in short term US rates following the Federal Reserve's mid month meeting. The secondary effects of that decision were to nudge markets toward the view that the Fed is keener on a rising interest rate cycle based on current data and less prone to prevaricate or wait for inflation.

Since the Global Financial Crisis, the Fed has hung behind the curve, reasoning that it is better to take a measured risk on inflation than choke a tremulous recovery. We surmise that conditions are sufficiently normal, 10 years on, for normalisation of policy to take place via the scaling down and elimination of QE measures and a move to more neutral interest rates. A new term has been coined: QT or Quantitative Tightening.

When rates move to normal and inflation remains abeyant, the prices of high duration assets suffer. A high duration asset is an asset whose cash flows are parked further out in the future than a low duration asset. Examples of high duration assets would be 30Y bonds (inflation linked or unlinked) high valuation stocks, expensive property or concept technology stocks. Examples of low duration assets would be low valuation stocks, deep cyclicals, mining companies, Argentinian bonds, Chinese banks.

We are entering a domain where the frontline issue in markets valuation. Corporate earnings have not advanced in step with share prices. Valuations have inflated. The work that we undertake on companies we invest in on behalf of our clients evidences the widespread struggle of managements to sustain organic growth. Not surprisingly, acquisitions are being sought. Acquisitions make sense, especially as industrial regulators are either quiescent or focused on other places. *Viz* the attention European Commissioner Margrethe Vestager is paying to US Tech giants' practices.

Here in the UK, we are being run by a government straight out of that formative children's show *Blue Peter*: one held together with sticky tape. The UK's economic cycle is long in the tooth and likely to be crimped by overleveraged consumers and progressively more cautious big businesses.

The UK outlook is not so material for our clients' portfolios - we are global investors and happy to be so at this time.

We have added an element of portfolio protection in the past two months. The reason for doing so is our observation that share prices have advanced a long way without any notable change in corporate fundamentals. Quality of earnings streams, where it exists, is very well recognised and price to growth ratios have widened significantly.

Looking forward, the path of markets will be determined by the rough interplay between growth plus inflation versus the path of interest rates. Under conditions where some combination of growth and/or inflation hold their combined heads up then a portfolio should tend toward real assets. Should they begin to fail, we would become progressively more defensive.

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