GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary - June 2017

FTSE 100	**7,547**	S&P 500	2,439
Resistance	7,620	Gold	**$1,280**
Support	7,200	GBP/EUR	1.1436
VIX	9.8%	GBP/USD	1.2881

Introduction:

As indices hover around all-time highs, investor unease remains palpable. Partly that is seasonal as *"sell in May and go away"* reminders litter the financial press. Partly it is logical, as the market has logged a 10% gain in the past six months - equivalent to more than an average year's gain. ETF outflows are now signalling that risk is being taken off the table. As a result, the equity market is lacking the breadth and conviction that would reassure bulls. Whilst we see few signs of an imminent bear market/recession, there are plenty of catalysts for a 5%-10% pullback. Thus, for new money we advise waiting for a more opportune moment to deploy cash into equities.

Market Outlook:

Over the long term *(since 1962), the FTSE All-Share has returned 7.2% per annum and that does not include the average 3.8% dividend yield earned on top. Therefore, 'strategically', it pays to be in the market. Also, considering inflation averaged 6.2% over the same period, it is vital that an investor invests in equities in order to preserve the purchasing power of their money. However, markets can be subject to swings in the interim and investors should be mindful of these with a view to protecting their capital and thus maintain a 'tactical' view.*

Our allocation to the stock market remains at neutral. If you're already invested, you should stay invested but for new money, we are sure that more opportune moments are around the corner.

The case for a strong bull or bear market is not so clear cut. Bears say that:

1) valuations are rich
2) the cycle is too old
3) the era of easy money is over
4) leverage is high/the credit cycle is over, and
5) wage inflation will cripple margins.

The bulls argue that:

1) there is synchronized global growth
2) stimulus will boost growth
3) we are in an economic upswing, and
4) lower rates justify higher valuations.

Market Commentary (cont)

Market Outlook (cont):

Considering that we are now in the summer months, investors should be cautious.

Once this period of uneasiness is out of the way however, we remain constructive on equities. It is true that equity markets are expensive on almost any metric, but valuation is a terrible short-term indicator.

Today's levels suggest lower long-term returns, but even those returns generally stack up well vs other asset classes. We continue to see limited risk of recession, given strong underlying fundamentals in the economy such as relatively full employment and rising wages, which are increasing consumer buying power.

In our view, the biggest upside risk to the market is driven by capitulation-like inflows into stocks in euphoria. Euphoria typically ends a bull market, and has been glaringly absent during this eight-year bull market.

Recommended Investment:

City Merchants High Yield 199p, 5.0% yield, 1% TER

City Merchants High Yield Trust Limited ("CMHY") is a Jersey-incorporated investment trust listed on the London Stock Exchange. Its investment objective is to obtain both high income (a high level of dividend income relative to prevailing interest rates) and capital growth from investment in high-yielding fixed-interest securities and also in equity-like investments such as preference shares.

<u>Management</u>

The fund is managed by Paul Read, Paul Causer and Rhys Davies of Invesco Perpetual. They form part of Invesco's well-resourced fixed interest team of 19 investment professionals, which is responsible for AUM of over £28bn. The team's investment universe comprises all Euro and Sterling high yield securities and each analyst has sector coverage responsibilities. The team therefore has top-down sector views as well as individual company credit views. The managers take a pragmatic approach to valuation and are not particularly model driven. In essence, they seek to avoid investments where they feel the yield is not sufficient for the level of risk being taken.

<u>Track record</u>

CMHY has an excellent track record, with the NAV having risen 65% over the last five years, comfortably outperforming its benchmark.

<u>Investment Style</u>

The portfolio holds a range of high yield bonds along with an allocation to investment grade corporate bonds. It is actively managed and typically consists of around 100 individual positions to ensure that the portfolio is diversified (individual positions are limited to 15% of the portfolio), having regard to the nature and type of securities (duration, credit rating and liquidity) and the geographic and industry sector composition of the portfolio. The managers pay little regard to any benchmark weights and security selection is focused on well-seasoned issuers that Invesco believes provide a good balance of risk and return. In addition, they have significant exposure to other areas of the market that they believe still offer relatively attractive yields such as corporate hybrid bonds.

Market Commentary (cont)

Recommended Investment (cont):

Summary
The fund's fully covered dividend yield of 5%, paid in quarterly instalments, is very attractive in today's low interest environment. While the fund's shares continue to trade at a premium to net asset value, we take comfort from the fact that they have traded at close to NAV for a number of years. Furthermore, given investor's continued demand for yield, we would expect the shares to be well supported. **Buy.**

Tweet of the Month:

"There is good evidence to suggest that we should use rules rather than unaided judgment when investing in stocks"

Simple rules work. It has been proven that buying 'defensives' or 'momentum' stocks or following the '10-month average' and 'sell in May' rules beat the market on average over the long term.

This is not a recent finding, nor even one confined to investing. In 1954, psychologist Paul Meehl discovered that medical statistical models often outperformed doctors' subjective judgments. And in 1979 Robyn Dawes found that even very rough statistical models were often better than expert opinion: models don't even have to be 'optimal' to be useful.

We have, therefore, good evidence to suggest that we should use rules - algorithms - rather than our unaided judgment. Which poses the question: why don't we do so more often?

Some recent experiments by Jennifer Logg of Harvard Business School shed light on this question. She found that people are not intrinsically averse to using algorithms, indeed quite the opposite. When given the same advice from an algorithm and a human, people preferred the algorithm even when told that the human was an expert. Why then, the reluctance to use algorithmic rules more in investing?

One reason is path-dependency. We believe things today because we believed them in the past: this tendency to under-react to new evidence is one reason why momentum investing works. Because we relied on judgment in the past, we continue to do so today.

Another reason is that we love stories. And humans tell us these, whereas algorithms do not.

But there's something else. Dr Logg's work found that experts rejected algorithms in favour of their own judgment even when the algorithms were good. *"Algorithmic advice falls on deaf expert ears,"* she says. Perhaps this shouldn't surprise us. Algorithms are a threat to experts' jobs and as Upton Sinclair said, *"it is difficult to get a man to understand something when his salary depends on his not understanding it"*.

And herein lies a good reason why retail investors should distrust some algorithms. 'Experts' can exploit our trust in science to rip us off. A team of Swiss economists has shown that this is what happens with structured products - high-charging but opaque assets that promise to protect us from downside risk.

We must, therefore, always ask: what's behind the algorithm. For good ones, such as momentum or defensive-based investing, we have abundant published scientific backing. Bad ones, however, are more like black boxes. When these come with high fees, we should be very wary of them.

Market Commentary (cont)

Trader's Corner:

Quarterly Sector Strategy

The following sectors have been found to be the strongest/weakest in the FTSE 350 over the year's four quarters:

Quarter	Strongest Sector	Weakest Sector
1st	Industrial Engineering	Banks
2nd	Personal Goods	Construction & Materials
3rd	Technology Hardware & Equipment	Industrial Transportation
4th	Chemicals	Banks

This suggests a strategy which cycles a portfolio through the four strong sectors throughout the year - Industrial Engineering from 1st January to 31st March, Personal Goods from 1st April to 30th June, Technology Hardware & Equipment from 1st July to 30th September and Chemicals from 1st October to 31st December. Over the last 10 years, this strategy would have grown a £1,000 portfolio into £13,300, compared with a buy and hold in the FTSE All-Share of £1,669.

Investors looking to trade this strategy could look to buy shares in SuperGroup Plc in the second quarter (1558p, 18.4x P/E, 1.7% yield, 19% upside to average broker target). More sophisticated traders may look to use a CFD to gain leveraged upside to the sector as well as create their own hedge fund by shorting the weakest sector whilst going long the strongest sector via CFDs.

Seasonal Tendency

In an average month, the market starts strong, hitting its month high on the second or third trading day, but prices then drift down steadily for the rest of the month (the third week is the second weakest of all weeks in the year). *Going short the market via a CFD after the third business day would be the best way to capture this move.*

Weakest Weeks

The week starting the 19th of June is the 2nd weakest week of the year, falling 74% of the time, posting an average loss of 0.7%. *Going short the market via a CFD would be best to capture this move.*

Option of the Month

Sell Imperial Brands September 3400 puts at 42p

Core defensive stock with 19% potential upside to the average broker price target, whilst yielding 4.7%. *Click here to view our guide to the Traded Options Market.*

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Market Commentary (cont)

Quote of the Month:

"There is nothing riskier than the widespread perception that there is no risk" - Howard Marks

Many like to measure risk by looking at measures of volatility, but the riskiest time in markets is invariably when the common view is that there is no risk for it's often around this point that everyone who wants to invest has already done so leaving the market vulnerable to bad news.

Economics:

The Office for National Statistics has revealed that UK GDP grew just 0.2% in the first quarter of 2017, a marked change of pace from the 0.7% growth in the final three months of 2016. Statisticians had previously estimated the economy grew 0.3% in the first quarter. The figure provides the latest evidence that the early resilience to the EU referendum result last June is now wearing off as higher inflation puts consumers under pressure. Prices have been picking up pace since the Brexit vote because it sent the pound sharply lower and has raised the cost of imports to the UK. That higher inflation has hit household budgets and dented the key driver of UK growth, consumer spending. On the positive side, a weak pound and a recovering global economy are helping businesses. As a result, UK growth is likely to tilt away from the consumer towards exports and manufacturing. This could keep the UK economy growing at a similar rate to last year.

Europe's economic recovery is showing surprising strength, as key surveys of business activity and optimism hit their highest levels in years. IHS Markit's key purchasing manager's index, a broad gauge of economic activity for the Eurozone, remained unchanged in May at a six-year high of 56.8. The results are consistent with quarterly economic growth of 0.6%-0.7%, higher than the first quarter's 0.5% growth. Job creation has surged to the second-highest in nearly a decade as firms expand capacity to meet rising demand. The strong data suggests the Eurozone is closer to tapering its €60bn-a-month QE programme. Analysts expect the bank could, at its meeting on 8th June, reveal a roadmap for tapering the stimulus as early as September.

May's disappointing job growth delivered another blow to hopes that the US economy is on the cusp of breaking out. Job creation fell well short of economist expectations, with just 138,000 new positions created against estimates for 185,000. The unemployment rate declined to a 16-year low of 4.3%, but that was because of a drop in the labour force participation rate. More broadly, though, the numbers serve as a reminder that hopes for breakout growth this year are likely to be dashed, and in fairly short order. As Washington lawmakers struggle to push through President Donald Trump's pro-growth agenda, the reality is sinking in that any gains now are likely to be felt in 2018 at the earliest.

Investment Calendar:

2nd June	US Nonfarm payroll report
8th June	ECB Meeting
9th June	Full moon (markets tend to reach a low point around this time)
13th June	Two-day FOMC meeting starts
15th June	MPC interest rate announcement at noon
16th June	Options Expiry Day
19th June	2nd Weakest Week
24th June	New Moon (markets tend to reach tops around this time)

Market Commentary (cont)

Seasonality: *"History doesn't repeat itself, but it does rhyme" - Mark Twain*

The January Barometer

Historically, the returns in January have signalled the returns for the rest of the year. If they are positive, the returns for the whole year tend to be positive and vice versa. First mentioned by Yale Hirsch in the Stock Trader's Almanac in 1972, a variant has it that returns for the whole year can be predicted by the direction of the market in just the first 5 days of the year. Judging by the first 5 days, 2017 is likely to be a positive year for the stock markets.

June

The variation in performance that exists between the 12 months of the year is statistically significant. For example, December is the FTSE 100's best performing month since 1984, rising 2.5% on average, 86% of the time. *June is historically the 2nd worst performing month, rising just 39% of all the time, with an average return of -0.9%. The market falls can also be quite large - the FTSE has fallen over 3% in June in seven years since 1984.*

Second Quarter

The FTSE 100 has risen 20 of the 33 years between 1984 and 2016, posting an average gain of 1.0%.

Sell in May and go away; don't come back till St Leger Day

Historically, this is the worst time of the year. Since 1966 to 2009, the FTSE All-Share has returned an average of just 0.7% between May Day and Halloween (it is known as the Halloween effect in the US) compared with 7.8% between Halloween and May Day. Some investors, therefore, tend to reduce exposure to the stock market from May. Our pagan ancestors knew this, which is why Beltane is a time of festivity (where people look ahead to fertility, plenty and joy) while Samhain marks the beginning of the "darker half" of the year. In March & April lighter evenings and warmer days cheer us up, which makes us more willing to take risks such as buying shares. So prices rise to high levels, which are difficult to sustain over the summer. In the autumn the darker nights make us more gloomy, with the result that prices fall to low levels from which they recover.

First-Year U.S. Presidential Cycle

The stock market tends to bottom out during the second year of each new presidential term and then recover strongly in the final two years. This is due to each Administration ensuring that the economy is strong by re-election time. Unfortunately, the excessive stoking of the economic fires creates excesses, including over-priced stocks, leading to poor stock market returns in the first two years of the next term. Since 1948, the UK market has risen 14 times out of 17 (82%) in US election years, with a rather extraordinary average annual return in those years of 33%. Generally, the UK market tends to rise in the few weeks leading up to the election.

Chinese New Year - Year of the Rooster

Chinese calendar revolves around a 12 year cycle where each year is associated with an animal (rat, ox, tiger, rabbit, dragon, snake, horse, sheep, monkey, chicken, dog and pig). Each New Year starts between 21st January and 21st February, the exact date being dependent upon a variety of complex factors. The best performing animals since 1950 have been the goat and the dog. The worst performing animals have been the rooster and the snake. *This year is the year of the rooster, the worst year of the Chinese zodiac historically for equities, with negative returns averaging 2.7% for the S&P 500.*

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Market Commentary (cont)

Seasonality (cont):

Market's Decennial Cycle

Since 1801, the strongest years for the FTSE All-Share have been the 2nd, 3rd and 5th years in the decades. The market has risen 14 out of the 21 decades in these years, with an average return of over 4%. The weakest has been the 10th being the only year to have a negative average change (-1.2%).

The 7th year is not one of the stronger years, but has still been positive in 10 of the 21 decades (57%), rising on average 2.7%.

Technical Analysis:

With the market at all-time highs, we feel that a pullback is now the likely scenario as we enter the second weakest month of the year for stocks. The market is 438 points above the 200 moving average and with the ADX at 24, the 20 day moving average lying at 7,470 looks a natural short-term target. An additional bearish factor is the fall of the RSI from above overbought territory to below the significant overbought 70% level. This indicates that the bullish momentum recently seen in the equity markets is breaking down. We believe a retracement is on the cards and that traders should position themselves accordingly.

"The illusion of randomness gradually disappears as the skill in chart reading improves" – John Murphy

Chart Legend:

(red dashed line)	20 day moving average	(signifies the short-term direction of the security. prices tend to gyrate around their 20 day m/a)
(red line)	50 day moving average	(signifies the medium-term direction of the security)
(red thick line)	200 day moving average	(signifies the long-term direction of the security - whether it is in a bull or bear market)
(blue line)		(an indicator that measures 2 standard deviations away from the 20 day m/a)

Technical Analysis Guide:

RSI (relative strength index) - indicates whether a security is overbought (above 70) or oversold (below 30). Also when the RSI moves above 50 that is considered bullish (or vice versa).

ADX (average directional index) - indicates whether a security is in a trend (above 20) or not in a trend (below 20). For trending markets moving averages work best when considering lines of support/resistance.

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