GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary - July 2016

FTSE 100	**6,590**	S&P 500	2,129
Resistance	6,730	Gold	$1,358
Support	5,800	GBP/EUR	1.1751
VIX	13%	GBP/USD	1.2985

Introduction:

Despite all the confident predictions of investment banks, political commentators and the bookmakers, the British electorate did the unthinkable and voted to leave the European Union. Having enjoyed a time of relative stability, with only modest uncertainty about the outlook, we have now entered a period defined by exactly the opposite. What is just as surprising as the result is the fact that the FTSE 100 has risen 7.8% over the last month.

Economics:

The evidence is piling up - Britain's decision to leave the EU is already hitting the economy. Market research firm GfK has found that consumer confidence took a dive in the wake of the referendum with its core index of consumer confidence dropping 8 points to -9 in July, its lowest level since December 2013. Analysts are warning the British economy may be heading toward an outright recession given that employment growth is likely to slow and a rise in inflation caused by the pound's fall will erode households' spending power. Moody's said Britain's economic outlook has "*significantly weakened*" and the country's status as one of the largest recipients of foreign direct investment in Europe "*is also likely to be damaged by the decision to leave the EU.*" Most economists expect the Bank of England to look to stimulate the British economy at next week's policy meeting. Some expect the central bank to reduce its benchmark interest rate to a new record low from 0.5%, where it has been since March 2009.

Meanwhile, the International Monetary Fund has downgraded its projections for growth in the euro area, arguing the UK's decision to leave the EU will dent the region's economic recovery over the next two years. The IMF said on Friday that it expected the Eurozone's economy to grow by 1.6% this year and 1.4% in 2017, down from earlier estimates of a 1.7% expansion for this year and next. The IMF's estimates are based on the UK and the EU reaching a favourable deal on Brexit close to the so-called Norway model, in which Britain continues to have access to the EU single market. While such a scenario would limit the economic damage from Brexit, a deal may be politically problematic because it could leave the UK unable to impose limits on immigration from within the EU.

US job growth surged by 287,000 in June (vs. an expected increase of 175,000) as manufacturers and other employers boosted hiring but tepid wages suggest the Federal Reserve will probably not raise interest rates anytime soon. "*For the Fed, this report is likely to offer some encouragement on the underlying labour market backdrop, though it is unlikely to change the current 'wait and see' policy stance as they assess the fallout from the Brexit vote,*" said Millan Mulraine, deputy chief economist at TD Securities. Financial markets expect no further increase this year, but economists believe a December hike is possible if the economy continues to grow and add jobs at a steady rate.

Market Commentary (cont)

Technical Analysis:

Following a 608 point rally in the FTSE 100 since reaching its nadir on the 27th of June, we feel the market is overstretched at current levels and highly susceptible to a pullback. The main market is now 329 points above its 20-day moving average and we see a retracement back to this level a distinct possibility sometime over the next few months. We see support at the lower Bollinger band (5,800) and resistance at the upper Bollinger band (6,730) given the market's lack of momentum.

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

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. Considering the FTSE 100 fell both during the first 5 days and the month as a whole, 2016 is forecast to be a negative year for the stock markets,.

July ☺

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. September is the worst month of the year, rising just 47% of the time, with an average return of -1%. *July is historically the 4th best performing month, rising 56% of all the time, with an average return of 1%. So, after a usually disappointing May and June, shares tend to perform a bit better this month.*

Third Quarter ☺

The FTSE 100 has risen 20 of the 33 years in the third quarter between 1984 and 2015, posting an average gain of 1%.

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.

Fourth-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.

Market Commentary (cont)

Seasonality (cont):

Chinese New Year – Year of the Monkey

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 chicken and snake.

This year is the year of the monkey, an average year of the Chinese zodiac historically for equities, with positive returns averaging 7.3% for the S&P 500.

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 6th year is one of the weaker years, having been positive in 12 of the 21 decades (57%), rising on average 1.6%.

Quote of the Month:

"We ignore outlooks and forecasts…we're lousy at it and we admit it …everyone else is lousy too, but most people won't admit it" - Martin Whitman

The longer we work in this business, the more we realise that nobody really knows anything. Your opinions are just as valid as those of the likes of Goldman Sachs. Brexit was a case in point, where most investment banks did not have it as their base case scenario, generally assigning a probability to it of no more than 30%. Even the bookies, who generally forecast such events accurately as they have "*skin in the game*", believed there was a 92% chance of a Remain vote on election night.

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 turns to underweight. The vote to leave the EU and the sheer uncertainty about what happens next in the UK makes it a much less attractive country for global companies to invest as their gateway to the European market.

The UK's vote to leave represents a significant global shock, as it suggests markets have underestimated the willingness of populations to upset the status quo. The likelihood of additional anti-globalisation events has consequentially risen. The resultant risk to global growth and multi-decade high profit shares is significant, and as a result, so is the threat to risky asset prices.

Market Commentary (cont)

Market Outlook (cont):

Economic forecasts for the UK have been slashed, with economists now expecting:

	2016	2017	
GDP	1.5%	1.4%	Due to lower consumption growth and lower investment
Inflation	0.9%	4.0%	Due to higher import prices
Unemployment	5.1%	5.2%	
Bank rate	0.25%	0.25%	

Economic growth is likely to be wiped out in the second half of the year, as uncertainty will weigh strongly on investment and hiring, even if trade relations hold throughout the lengthy political process the Brexit provokes, which could last several years.

On the plus side, we do not expect the BoE's MPC to have much of a tolerance for a potentially severe negative near-term growth outlook. To limit downside risks to growth and support nominal demand, we expect the BoE to cut the bank rate by 25bps during their August meeting as a precautionary measure. Further action may also come in the form of Quantitative Easing with the MPC likely to begin purchasing £100bn of assets over a 12-month period, beginning in Q4 2016. We also see the chances of a FED hike this year fading away. With the US Presidential Elections in November all but ruling out a November rate hike, this only leaves the December FOMC meeting as a possibility. Indeed, in voting to leave the EU the UK may have shot itself in the foot, but at just over 4% of global GDP it is not significant enough to derail the world economy.

We recommend a defensive posture across asset classes: Quality, Growth & Defensives across Europe and the US, quality corporate bonds, short periphery debt, underweight EM and commodities, and long JPY and USD versus all European currencies.

Longer-term, the economic implications of the referendum concern the divorce settlement that the UK negotiates with the EU over the coming years. Given that immigration restriction was a major issue for voters, a 'soft exit' that preserved Single Market access and free movement of labour may not be plausible. This suggests that a harder, more uncertain exit is a real possibility.

Tweet of the Month:

"*Some sectors have fallen by as much as 40% following the EU Referendum. We see some major value opportunities at these levels*"

The implications of the UK's exit from the European Union are still unclear. What is clear is that many stocks have fallen below their intrinsic value. In this article, we look at the banks, life insurance, home construction & media sectors and select three shares from each with good upside to the average broker price target.

<u>Banks</u>

European banking stocks lost 22% of their value in the two days of trading following the UK's EU vote, inching closer to the all-time low hit during the financial crisis four years ago.

Market Commentary (cont)

Tweet of the Month (cont):

Lower for longer interest rates and the threat of weaker demand within the UK housing market mean investing in the UK banking sector has become riskier post-vote. However, we believe there are opportunities for investors in the sector, albeit those with a slightly higher risk appetite. Lloyds, for example, now trades on just one times its forecast tangible book value per share. This is compared with 1.3 times prior to the EU referendum.

Company	Price	Potential Upside	P/E	Yield
Barclays	139.25p	54.0%	7.9x	2.2%
Lloyds TSB	52.6p	47.4%	7.4x	8.3%
Virgin Money	214.9p	107.4%	6.6x	3.2%

Life Insurance

Encouragingly, some insurance groups - specifically Legal & General and Aviva have come out fighting. L&G said its strategy is based on five key factors - ageing populations, globalisation of asset markets, creation of new real assets, welfare reform and digitalisation - all of which will be "*substantially unaffected by the EU Referendum result*". Similarly, Aviva said it had conducted "*extensive analysis*" of the possible implications of a vote to leave the EU and considers it will have "*no significant operational impact on the company*".

Company	Price	Potential Upside	P/E	Yield
Aviva	363p	49.7%	7.2x	6.7%
Legal & General	177p	44.4%	8.4x	8.1%
Prudential	1220p	32.6%	10.3x	3.4%

Home Construction

Shares in housebuilders all received a big mark down following the referendum that we feel is hard to justify given the huge imbalance between the supply of homes and demand. To justify the fall in share prices there has to be a material decline in demand, and as yet, it is still too early to identify whether potential buyers have changed their minds. But everyone has to live somewhere, which suggests that demand for new homes could be underpinned by growth in the private rented sector at the very least.

Just last week, Redrow announced that profits for the year to June will be at the top end of expectations, and pointed out that even after the referendum vote there was a queue of potential buyers at its latest sales site. This tends to suggest that the mark down in prices has been overdone, and we feel that even if margins are slightly eroded, the supply/demand imbalance will provide a major pillar of support. For investors reloading now, there is also the yield factor to consider, with dividends in some major builders over 8%.

Company	Price	Potential Upside	P/E	Yield
Berkeley Group	2491p	40.3%	6.2x	8.0%
Crest Nicholson	418.3p	73.1%	6.1x	7.4%
Taylor Wimpey	131.5p	71.0%	7.6x	8.4%

Market Commentary (cont)

Tweet of the Month (cont):

Media

Media companies have been among the hardest hit by Brexit. Analysts expect the current uncertainty to weigh on advertising demand, tempering the growth outlook for television, radio, newspaper and magazine publishers. But investors should pay attention to each company's fundamentals. For instance, shares in ITV plunged a fifth within hours of the referendum, as sellers overlooked the attractive rating, large dividend yield and the potential for a takeover offer.

Company	Price	Potential Upside	P/E	Yield
Auto Trader Group	303p	41.3%	22.8x	1.4%
ITV	180.8p	48.6%	10.6x	4.1%
Sky	864.5p	32.5%	13.9x	4.0%

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 Laird Plc in the third quarter (310p, 12.4x P/E, 4.3% yield, ~30% 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 start of the month tends to be strong. After that, the market has a propensity to drift lower for a couple of weeks until finishing strongly in the final week of the month. *Going long the market via a CFD before the final week of the month would be the best way to capture this move.*

Strongest Days

The 29th of July is the 8th strongest day of the year, rising 77% of the time, posting an average gain of 0.4%. *Going long the market via a CFD would be best to capture this move.*

Weakest Days

The 8th of July is the 6th weakest day of the year, falling 70% of the time, posting an average loss of 0.2%. *Going short via a CFD would be best to capture this move.*

Option of the Month

Sell IAG September 320 puts at 5.25p

Strike price at an 18-month low. Stock is trading on a P/E multiple of just 4.8x, yields 5.6% and has 96% potential upside to the average broker price target. *Click here to view our guide to the Traded Options Market.*

Market Commentary (cont)

Recommended Investment:

Equities

Following the referendum, we recommend that investors stick to Quality, Growth and Defensive stocks across Europe. In particular, we advise investing in the following themes:

1-Overweight sustainable dividend payers

These should benefit from further downside for bond yields. Our sustainable dividend screen features European companies with a 12m forward dividend yield of more than 3%, DPS cover of more than 1.4x, no dividend cuts over the past 10 years and positive projected consensus DPS growth between 2015 and 2017.

Company	Price	P/E	Yield	Price Target	Potential Upside
Greene King	753.5p	10.1x	4.5%	1009	34%
Sky	869p	13.9x	4.0%	1145	32%
LVMH	135.78	15.5x	3.2%	172	27%
Daily Mail & GT	628.5p	11.7x	3.6%	754	20%

2-Overweight high US sales exposure

These companies tend to outperform when the USD rises. The following European companies receive more than 40% of their total revenues in USD.

Company	Price	P/E	Yield	Price Target	Potential Upside
Aegon	3.37	4.9x	8.2%	4.97	47%
Alcatel-Lucent	3.48	11.6x	0.0%	4.82	39%
Fiat Chrysler	5.59	3.2x	0.5%	7.72	38%
Autogrill	7.50	18.6x	1.9%	9.61	28%
Fresenius Med ical	79.66	19.3x	1.2%	95.4	20%

We have removed from the screens all stocks with less than 20% potential upside to the average broker price target.

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Market Commentary (cont)

Investment Calendar:

July is the second busiest month for FTSE 100 interim results

1st July	Nonfarm payroll report
4th July	New Moon (markets tend to reach tops around this time)
8th July	6th Weakest Market Day of the Year
14th July	MPC interest rate announcement at 12 noon
17th July	Options Expiry Day
19th July	Full Moon (markets tend to reach a low point around this time)
21st July	ECB Meeting
25th July	Two-day FOMC meeting starts
29th July	8th Strongest Market Day of the Year

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)
thin red line	50 day moving average	(signifies the medium-term direction of the security)
thick red line	200 day moving average	(signifies the long-term direction of the security - whether it is in a bull or bear market)
blue line	bollinger bands	(an indicator that measures 2 standard deviations away from the 20 day m/a)

Technical Analysis Guide:

<u>RSI</u> (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).

<u>ADX</u> (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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