Beckford · James

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December 2016 Portfolio Review

Well the year ended much more positively than it began, though there is a strong potential for headwinds in 2017; more about which later.

In Italy, the apparent disaster of the ailing Monte dei Paschi di Siena (MPS) has been decisively avoided. It was hoped that a last-minute recapitalisation plan from the private sector would avoid the need for state intervention, but the European Central Bank's (ECB) refusal to extend the deadline for the scheme meant fears over the MPS' liquidity levels. The plan, led by US bank JP Morgan, failed to find an anchor investor, precipitating the deal's collapse, and leaving the government little choice but to step in with a €20bn bailout package to stop a default which could risk a financial contagion across the nation's and perhaps Europe's banks. Despite this, the state bailout is politically very unpopular among the Italian public, because the bailout package will force some losses on junior bondholders – many of them Italian retail investors. New EU rules concerning the injection of public funds to save banks state require junior bondholders must take a share of the hit, converting their bond holdings into equity.

In the same vein, the much discussed fine from the US authorities for Deutsche Bank (DB) came in considerably below the $14 billion headline-grabbing figures first bandied around three months ago. The now imposed roughly $7bn settlement is more in line but still slightly above what the bank had made provisions for – but will certainly not mean the ruin of the bank.

So, whilst a number of downside shocks have materialised, they have flattered to deceive. Once again, markets have shrugged off the fear and kept on climbing towards better things, with a strong end to the year and a continuation of the normalisation of conditions. The recent bond selloff appeared to be coming to an end as yields have stopped the steep incline of recent months, the situations of MPS and DB (mentioned above) are drawing to a close, the currency volatility of the past year is dampening down and economic indicators are finally beginning to catch up with the slightly surprising buoyancy of markets over the second half of 2016.

So what of 2017? That there is more uncertainty than usual is not in doubt, and nor is the existence of a range of possible outcomes — good and bad — for both Britain and the global economy. Those that will occupy us over the next 12 months, and no doubt there will be more, are Brexit, European politics (and the interaction of the two), Donald Trump's America and China (and their interaction, too).

Even before Trump, inflation looked to be stirring. In the UK, the Brexit-driven depreciation of sterling will result in higher prices this year when currency hedges unwind, and this is before we trigger Article 50 and with it another possible round of uncertainty. This devaluation of sterling and Opec's agreement to cut oil production, means inflationary pressures are building in the UK and therefore UK government bonds are likely to underperform. In Europe, headline inflation numbers are also creeping up and there are the added political uncertainties of elections in the Netherlands, France and Germany. The necessary political hardball will mean Brexit negotiations should create their own level of doubt.

Trump's policies are likely to be reflationary, with tax cuts and higher expenditure on infrastructure. Government borrowing will increase. Faster growth combined with less immigration could see wages start to rise more quickly, increasing inflationary pressures and putting pressure on the Federal Reserve to raise interest rates. All in all, these fundamentals will be negative for US Treasuries, and a commensurate increase in growth (expectations) and corporate earnings, will be expected or the word 'stagflation' could reappear

In Japan, unemployment is low and employers are struggling to fill vacancies. Eventually this should push wages up. Prime minister, Shinzo Abe, has announced plans to defer the increase in sales tax from 2017 to 2019. The rise in sales tax was initially meant to take place in 2015 and indeed may never be implemented as it is too unpopular and it is much easier to print money instead.

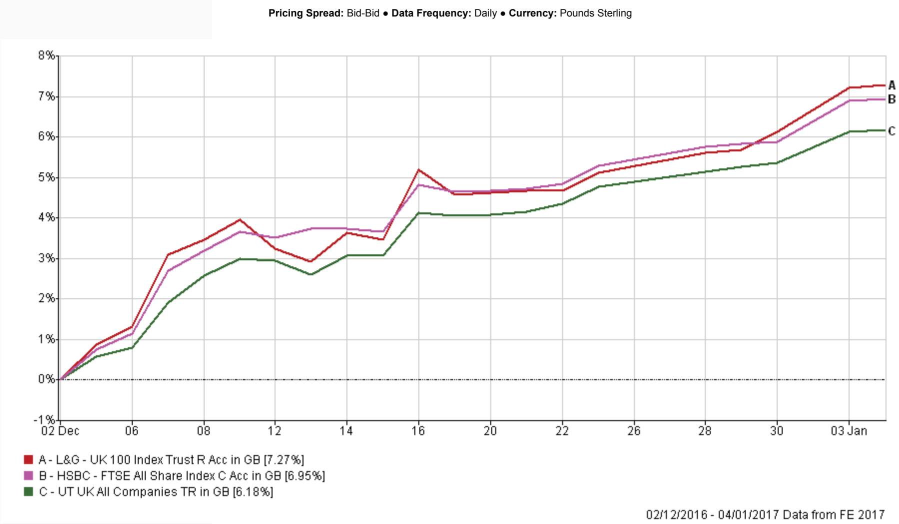
Commodity prices have risen sharply over the last year and this month Opec announced cuts in production, pushing the price of energy upwards. All in all, a lot to watch in 2017.

Portfolios

December's market surge illustrated the value in combining index tracking funds with actively managed funds, as we do in the Beckford James portfolios.

A fund manager asked (rhetorically) in a recent conference, 'if you think markets might take a short down-turn, where do you want to be, actively managed or in an index tracker which is guaranteed to go down with the market?' Therefore in flat markets or one's with downside potential, there is a value in holding active funds but if a market does surge, an active fund cannot capture the upside as clearly as a tracker.

Over the course of December, the 'Santa Rally' was fuelled in part by the relatively out of favour mining sector as the likes of Fesnillo and Randgold rose 5% and 4% respectively, and the banking sector where Lloyds and Barclays saw increases of 12.55% and 10.35% respectively. Many active funds have recently been underweight in these two areas, so relative performance for the month would have lagged if only actively managed. Indeed, as the graph below shows, the two UK trackers in the portfolio both outperformed the UK All Companies sector.



Long term data still shows that well managed active funds have given significant longer term outperformance, but the two working in harmony help to stabilise short-term performance. The debate of passive versus active will continue!

As we pass through the 7 year anniversary of growth portfolios, we are pleased to see returns for the last 12 months of between approximately 8% and just over 20% depending on risk profile and strategy. This has boosted client's assets significantly and in most cases above assumed targets. That said, it has been something of an anomalous year and we will be looking to rebalance portfolios with the aim of redistributing gains across portfolios while ensuring the quality of underlying funds continues to meet the high standards required for portfolio constituents.