

Viewpoint

Monthly market update

September 2016



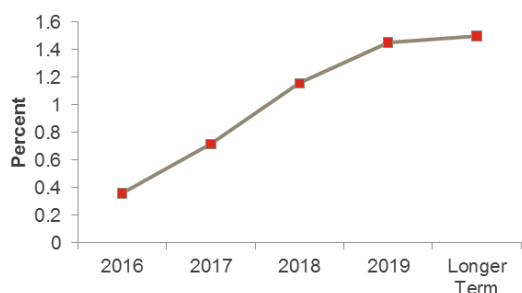
Contents

1. Market commentary	3
2. Market performance – Global	5
3. Market Performance – UK	7
4. Asset allocation dashboard	9
Important notes	11

1. Market commentary

The modest returns seen in the majority of markets over the month masked some sharp moves over the same period. In most cases these were triggered once again by central bank policy decisions, as well as moves by OPEC and Russia to curb oil production. Markets initially sold off quite sharply, disappointed that the European Central Bank (ECB) failed to loosen policy further, while also becoming increasingly worried that – in the face of broadly positive economic data from the US – the Federal Reserve (Fed) would raise rates at its September meeting. In the event, the Fed not only kept rates on hold but was more dovish than expected on their future course, motivating markets to recover lost ground and end the month largely unchanged. Based on the median forecasts of Federal Open Market Committee members, the Fed is now expecting to raise rates only once this year, and has lowered its median expectations for rate rises in both 2017 and 2018 by 0.5%, leaving the median 2017 and 2018 forecasts at 1.1% and 1.9%, respectively. However, a series of strong economic data releases together with a rising chorus of hawkish comments from Fed governors have increased the probability of a December hike to around 60%. Bond markets as well as interest rate sensitive equities such as utilities and REITS have been trending weaker on the news.

Figure 1: The average of Fed members predicted future base rate



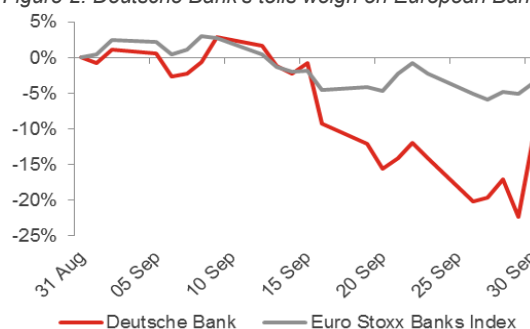
The other much anticipated central bank announcement came from the Bank of Japan's (BoJ's) policy meeting and review. It is now aiming to over-shoot its 2% inflation target while sticking to its quantitative easing annual target of buying JPY 80tn of Japanese Government Bonds (JGBs) until this inflation target is met. A further surprise was its announcement to focus on yield-curve control rather than a defined expansion in the monetary base. The

BoJ will now target a specific yield on ten-year JGBs, initially set at zero. Although the yen and JGBs were little moved on the announcement this was undoubtedly a significant shift in policy and highlights the growing concern among central banks, financial institutions and investors that monetary policy is losing its effectiveness.

The other significant development during the month was OPEC's preliminary agreement to curb oil production. Plans are to cut to 32.5 million barrels per day, lowering 2017 expected production by circa one million barrels per day. Precise country level production quotas will be decided at the end of November, but there remain doubts around the ability to implement the cuts. The oil price responded with a rise of over 10% from its mid-month lows and is now back above USD 50 per barrel for Brent crude. The oil price is now likely to be in a fairly narrow trading range, supported by slowly rising global demand and OPEC output management and capped by the likelihood of rising shale production at prices above USD 50.

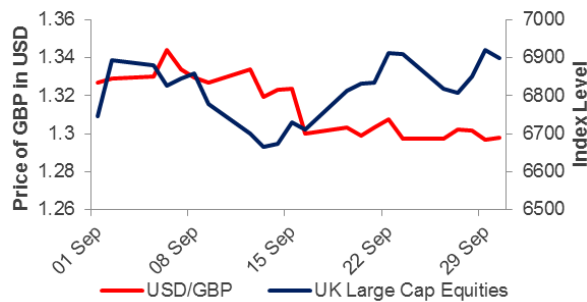
In Europe the problems of the banking system came back to haunt markets as the shares of Deutsche Bank came under severe pressure on concerns that the bank will need a large capital raising. The problems for banks in the Eurozone are several: weak profitability as a result of negative rates; large non-performing loans which have yet to be fully recognised; regulatory problems and massive fines from pre-crisis legacy problems. Further capital raising and equity dilution appears inevitable, and although Deutsche is too important systemically to be allowed to fail, the fact that EU banks remain weak eight years after the crisis is clearly unhealthy for the economy and a constraint on growth.

Figure 2: Deutsche Bank's toils weigh on European Banks



The UK economy continued to surprise on the upside with a series of strong data and growth forecast upgrades. However, Prime Minister Theresa May's announcement that Article 50 will be invoked by the end of March 2017, together with a clear signal that the government will prioritise restrictions on immigration over access to the single market, as well as cautious comments from the Chancellor of Exchequer on the future of economy in the short-term, triggered a renewed slide in sterling to a thirty-one year low against the US dollar. Although this benefits the export sector there are concerns that inflation will begin to rise as higher imported prices feed through. Sterling meanwhile is likely to remain out of favour given the high level of uncertainty regarding the terms of Brexit, and is getting to levels which are reaching good value.

Figure 3: UK equities have benefitted somewhat from sterling's weakness



Most markets have performed well so far this year, with yields on bonds falling sharply and bond markets delivering strong returns (especially in credit, high

yield and emerging markets) while equity markets have produced sharp gains since the big sell-off in January and early February. This has taken valuations to high levels across most asset classes, and to extreme levels of over-valuation in safe haven government bonds. Ultra-loose monetary policy has been a driving force for these returns as investors seek yield in a very low return environment. The Fed is keen to continue the process of policy normalisation that it started last year. As economic data improves and inflation begins to pick up, the likelihood is that there will be a rate rise in December. The US Presidential election introduces a level of uncertainty before any potential hike, however; Hillary Clinton would represent continuity and is the market's preferred choice, while Trump is an unknown and unpredictable, with the risk of causing market disruption in the short term. Meanwhile the effectiveness of ultra-loose monetary policy is increasingly being called into question and being seen as a risk. This is putting financial institutions under increasing strain and creating asset bubbles. The current cycle has further to run but the strong rise in markets in the past eight months has taken valuations to levels which are vulnerable to a setback. Investors should remain invested as we believe the global economy will continue to grow modestly without triggering a sharp increase in inflation while central banks will keep policy loose for a long time to come, but short term caution is warranted.

Source: Bloomberg. Returns in US dollars unless otherwise stated. September 2016.

2. Market performance – Global (local returns)

		To 30 September 2016		
Asset class/region	Index	Currency	1 month	Year-to-date
Developed markets equities				
United States	S&P 500 NR	USD	0.0%	7.3%
United Kingdom	MSCI UK NR	GBP	1.8%	14.4%
Continental Europe	MSCI Europe ex UK NR	EUR	-0.1%	-3.7%
Japan	Topix TR	JPY	0.3%	-12.7% ^e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	1.8%	12.3%
Global	MSCI World NR	USD	0.5%	5.6%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	1.4%	14.7%
Emerging Asia	MSCI EM Asia NR	USD	1.3%	13.0%
Emerging Latin America	MSCI EM Latin America NR	USD	-0.8%	32.2%
BRICs	MSCI BRIC NR	USD	1.6%	16.5%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	1.3%	16.0%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.1%	5.4%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.5%	7.7%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.2%	9.2%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.7%	15.1%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-2.5%	14.7%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-1.2%	13.7%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.2%	6.4%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.1%	6.0%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-0.6%	7.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.0%	5.4%
Australian Government	JP Morgan Australia GBI TR	AUD	-0.4%	7.0%
Global Government Bonds	JP Morgan Global GBI	USD	0.5%	10.8%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.5%	9.2%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	0.8%	3.1%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	0.5%	15.8%

Source: Bloomberg. e denotes estimate

		To 30 September 2016		
Asset class/region	Index	Currency	1 month	Year-to-date
Property				
US Property Securities	MSCI US REIT NR	USD	-2.0%	10.8%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	-4.4%	10.5%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	2.6%	9.8%
Global Property Securities	S&P Global Property USD TR	USD	-0.6%	10.9%
Currencies				
Euro		USD	0.7%	3.5%
UK Pound Sterling		USD	-1.2%	-11.9%
Japanese Yen		USD	2.1%	18.7%
Australian Dollar		USD	1.9%	5.1%
South African Rand		USD	7.3%	12.7%
Commodities & Alternatives				
Commodities	RICI TR	USD	4.0%	9.3%
Agricultural Commodities	RICI Agriculture TR	USD	2.8%	-0.3%
Oil	Brent Crude Oil	USD	4.3%	31.6%
Gold	Gold Spot	USD	0.5%	24.0%
Hedge funds	HFRX Global Hedge Fund	USD	0.4% ^e	1.1% ^e
Interest rates				
United States			0.50%	
United Kingdom			0.25%	
Eurozone			0.00%	
Japan			-0.10%	
Australia			1.50%	
South Africa			7.00%	

Source: Bloomberg. ^e denotes estimate

3. Market performance – UK (all returns in GBP)

Asset class/region	Index	To 30 September 2016		
		Currency	1 month	Year-to-date
Equities				
UK - All Cap	MSCI UK NR	GBP	1.8%	14.4%
UK - Large Cap	MSCI UK Large Cap NR	GBP	2.1%	16.7%
UK - Mid Cap	MSCI UK Mid Cap NR	GBP	0.5%	3.1%
UK - Small Cap	MSCI Small Cap NR	GBP	1.7%	5.3%
United States	S&P 500 NR	USD	1.3%	21.9%
Continental Europe	MSCI Europe ex UK NR	EUR	1.9%	13.1%
Japan	Topix TR	JPY	3.5%	18.6% ^e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	3.1%	27.6%
Global developed markets	MSCI World NR	GBP	1.9%	19.9%
Global emerging markets	MSCI EM (Emerging Markets) NR	GBP	2.6%	31.8%
Bonds				
Gilts - All	BofA Merrill Lynch Gilts TR	GBP	-2.4%	14.7%
Gilts - Under 5 years	BofA Merrill Lynch Gilts TR under 5 years	GBP	0.0%	2.8%
Gilts - 5 to 15 years	BofA Merrill Lynch Gilts TR 5 to 15 years	GBP	-0.8%	10.8%
Gilts - Over 15 years	BofA Merrill Lynch Gilts TR over 15 years	GBP	-4.7%	26.0%
Index Linked Gilts - All	BofA Merrill Lynch Inflation-Linked Gilts TR	GBP	-0.8%	28.6%
Index Linked Gilts - 5 to 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR 5 to 15 years	GBP	-0.5%	15.1%
Index Linked Gilts - Over 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR over 15 years	GBP	-0.9%	37.7%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-1.2%	13.7%
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.2%	19.8%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.1%	24.1%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.0%	30.8%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	2.2%	24.9%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.9%	24.4%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	1.3%	25.6%
Global Government Bonds	JP Morgan Global GBI	GBP	1.9%	25.8%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	GBP	1.8%	24.1%
Global Convertible Bonds	UBS Global Focus Convertible Bond	GBP	2.1%	17.2%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	GBP	1.8%	31.5%

Source: Bloomberg. ^e denotes estimate

Asset class/region	Index	To 30 September 2016		
		Local currency	1 month	Year-to-date
Property				
UK Direct Property	UK IPD All Property TR	GBP	0.0% ^e	-0.2% ^e
Global Property Securities	S&P Global Property USD TR	GBP	0.7%	26.0%
Currencies				
Euro		GBP	2.0%	17.5%
US Dollar		GBP	1.2%	13.5%
Japanese Yen		GBP	3.3%	34.8%
Commodities & Alternatives				
Commodities	RICI TR	GBP	5.4%	24.1%
Agricultural Commodities	RICI Agriculture TR	GBP	4.2%	13.3%
Oil	Brent Crude Oil	GBP	5.7%	49.5%
Gold	Gold Spot	GBP	1.8%	40.8%
Interest rates				
United Kingdom			0.25%	
United States			0.50%	
Eurozone			0.00%	
Japan			-0.10%	

Source: Bloomberg. ^e denotes estimate

4. Asset allocation dashboard

Positive	Neutral	Negative
Asset class	View	
Equities		
Developed equities		
UK equities (relative to developed)		
European equities (relative to developed)		
US equities (relative to developed)		
Japan equities (relative to developed)		
Emerging market equities		
Fixed Income		
Government		
Index-linked (relative to government)		
Investment grade (relative to government)		
High yield		
Loans		
Emerging market debt		
Convertible bonds		
Alternatives		
Commodities		
Property (UK)		
Currencies		
GBP		
Euro		
Yen		



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