J O Hambro Capital Management Group

Leyland's Global Look

FOR PROFESSIONAL INVESTORS ONLY

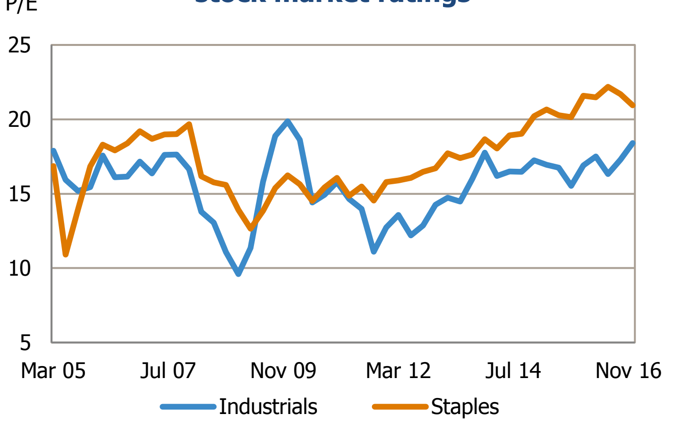
Ben Leyland, JOHCM Global Opportunities Fund

February 2017

Nowhere to hide – a new phase in global equity markets

There has been a dramatic rise in bond yields in the past six months: the US 10-year treasury troughed at 1.4% in June 2016 and is now around 2.5%. This surge in yields has driven a sharp rotation in the equity market in favour of more cyclically-exposed sectors, at the expense of 'bond proxies'. The chart below illustrates this shift clearly. Since June, the relative re-rating of industrials versus consumer staples has been 20%: industrials have re-rated by 13% whereas staples have de-rated by 6%.

Consumer staples versus industrials: stock market ratings



Source: Bloomberg as at 31 December 2016.

We believe we are starting the fourth distinct phase of the market cycle since 2011. We would characterise this quartet as follows:

2010-11: Spoiled for choice

Low valuations across the stock market, with no premium demanded for high quality and compound growth. This was a great time to be laying down capital in high quality franchises, such as Reckitt Benckiser, Sage, Microsoft and Accenture.

2012-13: The bull market in complacency

A rising tide lifted all boats, as consensus grew around a narrative of political stability, a 'goldilocks' economy, and worldwide quantitative easing. The VIX index (a measure of implied future volatility in equity markets – or an 'inverse complacency index') returned to levels last seen in 2006-7, and valuations across the board became more difficult to justify. We spent this period raising cash and prioritising quality compounders (e.g. MasterCard, TJX Companies) with enough growth potential to justify expensive short-term multiples.

2014-16: Value emerging

Monetary policy divergence, the collapse in commodity prices, a US industrial recession and, finally, the advent of greater political uncertainty, created rising divergence across the equity market. The re-rating of 'bond proxies' continued, but ratings for more cyclical and resource-sensitive companies went into reverse. For us, this created selective opportunities in names such as Inpex, Galp, Union Pacific, Woodward and Wartsila. Even whilst accepting less short-term cash flow predictability, our emphasis remained on quality franchises with strong balance sheets.

2016-?: Nowhere to hide

Average valuations are higher than ever, corporate leverage has risen significantly and geopolitical uncertainty is everywhere. The recent 'value' rally has broadly removed opportunity in cyclicals: what has rallied is no longer cheap and what has fallen is not yet attractive. Just as in 2013, we require genuine long-term compound growth to justify current multiples. Meanwhile, our cash balance remains high as we wait to see where the next opportunities will emerge. Our track record shows we can move quickly when they do.