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FOR PROFESSIONAL INVESTORS ONLY

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Capital Management Group

Under the Bonnet

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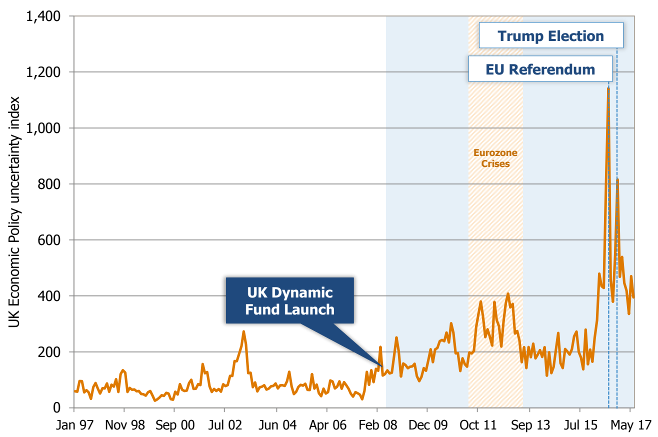
Investment background

June was a tougher month for UK equities, dominated by the somewhat surprising election outcome on the 8th June, which saw the Conservative party take a larger share of the national vote, up 5.5 percentage points since 2015, but lose seats overall and therefore fail to gain a parliamentary majority. This outcome, of course, creates further political and economic uncertainty in the UK (albeit not as uncertain as after the EU referendum, see below) and has had a further negative effect on investors' perceptions of and demand for UK-exposed assets.

Uncertain economic times



Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com. As at June 2017.

Economic data released prior to the election continued to paint a resilient picture of UK economic activity, albeit with a continued squeeze on household incomes given the rise in inflation sparked by sterling's post-EU referendum decline and the well-documented lack of wage growth within the UK (and in the public sector particularly). The PMI surveys for both UK manufacturing and UK construction showed resilience, with manufacturing at 57.6, only marginally down from the prior month, and construction rebounding to 56, up from 53.1 last month. Services came in at 53.8, down from 55.8 the prior month, affected by delays in decision-making ahead of the election. ONS retail spending for May was weak, growing by 0.9%, the lowest rate since April 2013.

Our thoughts prior to the election, outlined in the May edition of 'Under the Bonnet', were that we would see an easing of inflationary pressures as petrol price rises dissipated given recent oil price falls. These falls continued in June, with the Brent crude price closing at US$48/bbl, down 4.8% over the month and by 9.3% over the quarter. This is translating to lower prices at the pump as expected, and May saw the third successive month of petrol price declines. These declines will have continued in June, with the supermarkets all cutting prices further. We remain of the view that we are likely to see a moderation of inflationary pressures as the year progresses given continued commodity price declines, the annualising of sterling's post-EU referendum drop last month, the partial recovery in the sterling trade-weighted index from the lows and continued competition on the High Street.

On the labour front, data released in June showed continued strength in employment data, with a 74.8% employment rate for the three months to April 2017, the joint highest since records began in 1971. The unemployment rate was 4.6%, the joint lowest since 1975. This is despite weakness in the public sector, where employment at 17% of the workforce was at the lowest level since records began in 1999. The KPMG / REC survey for June confirmed the buoyant employment picture, with accelerating permanent staff placements in May, the highest rate of placements for over two years, coupled with the steepest declines in candidate availability for the last 16 months. Average permanent starting salaries increased at the fastest rate for the last three months. This contrasts somewhat with the continued weakness in the ONS data for average weekly earnings, which showed total pay for the three months to end April 2017 rising by 2.1%, down slightly on the prior three-month average.

Whatever happens on inflation and labour there is no doubt that confidence in the UK has taken a further knock in the wake of the election. GFK consumer confidence data for June, released at the end of the month (but only spanning the two weeks between the 1st and 15th June), shows the post-election dip in confidence, with the index declining from -5 to -10, feelings no doubt also negatively affected by the twin tragedies at London Bridge and Grenfell Tower on the 3rd June and 14th June respectively.

Looking at business sentiment, the Deloitte CFO survey for Q2 (data collated between the 12th and 27th June) showed a similar trend of caution in CFO spend intentions, with 72% of CFOs surveyed in Q2 expecting Brexit to have long-term negative effects on the business environment and an uptick in caution over likely forward spend. The Bank of England decision to increase the countercyclical buffer at UK banks in order to ensure the rapid growth in the consumer credit market and the current easing conditions in the mortgage market do not feed through to a bubble, whilst undoubtedly appropriate, adds to the current bearish sentiment surrounding the UK consumer.

Strategy update

The Fund performed resiliently in June, falling by 1.66%, which represented outperformance against its benchmark, the FTSE All-Share Total return Index (12pm adjusted), which fell by 2.21%. For the second quarter, the Fund rose by 3.09%, outperforming the index, which rose by 2.12%. At the halfway stage for 2017 the Fund is ahead of the benchmark, having returned 8.86% versus 6.77% for the index.

Sector allocation effects were positive for both the quarter and (particularly so) for June at +55bps and +42bps respectively. This represented 42% of the quarterly gross return (66% in June). One of the larger drivers of this positive mix was the substantial move in UK gilt yields over the month and the quarter, the 10-year yield rising by 21bps or 20% in June and by 12bps or 10% for the quarter, as the market started to think about the implications of inflation in the UK and QE tapering more broadly globally.

As a result, and unlike in the first quarter, when bond yields fell substantially, the Fund's underweight in consumer goods was not a drag on performance, with BAT and Imperial Brands both having a tougher quarter. Imperial Brands is now off 27.5% relative to the FTSE All-Share since its post-Brexit relative peak about a year ago and has substantially underperformed BAT. The Fund's maximum underweight in utilities was a benefit for the month and quarter for similar reasons. Industrials, the Fund's largest current sector overweight, was also positive for allocation. Interestingly given the consumer backdrop, the Fund's overweight in consumer services, a position we have gently been building since the start of 2017, contributed marginally positively to Fund performance in the quarter.

Looking at the individual stocks, **3i Group** was the main positive relative contributor for June, continuing the strength seen through all of Q2 during which it contributed 66bps of relative performance, second only to **Electrocomponents**, which contributed 71bps over the quarter. Both continue as top five active positions in the portfolio. **SIG**, a stock which we decided to repurchase for the Fund in January 2017 after both a management and strategic change, was the third-best contributor over the quarter in response to stabilising trading in the UK, a better outlook in the eurozone and improving sentiment around the management and strategic changes and what they might deliver. We will update more fully after the forthcoming interim results.

DS Smith performed well in response to the announcement of robust full-year results at the end of the month, but also to the announcement of the acquisition of 80% of US-based Interstate Resources for an enterprise value of c. £1.1bn. This previously family-owned business is involved across the entire packaging chain and offers a strong platform to grow in the US whilst also providing powerful synergy benefits both on costs (c. £20m) and revenues (both Mondelez and Nestle, key European customers for DS Smith but neither particularly big customers for the acquired company, have publicly welcomed the UK firm's entry into the US market). This looks like another good deal from DS Smith, which we support. The stock represents c. 1.7% of the Fund's capital.

On the negative side, **QinetiQ** fell 13% and delivered a negative contribution of 38bps. The move looks unusual in the context of recent stable results and an absence of new negative developments, albeit there remain ongoing fears over margin headwinds in the UK from 'Single Source Pricing' and current negotiations with the Ministry of Defence over the profit rate on a reasonably large portion of contracts for the next five years. Whilst we have long been of the view that these headwinds are both priced in to forward guidance and are mitigated by management actions, maybe other investors are taking a more cautious stance. It also doesn't help that QinetiQ is a contractor to the MoD at a time of political uncertainty in the UK. Either way, we reiterate that the real story here over the next few years is one of a management team that has moved aggressively to position this business for growth, something that in no way is being predicted in earnings forecasts, which are essentially flat over the next three years. Of eight analysts that cover the stock, there are currently no buyers (yes, none). This company is on an EV/EBIT multiple of c. 11x, has just moved to a material pension surplus, has £220m of net cash on the balance sheet, has made its first meaningful acquisition for c. 10 years, is in a unique position in the defence value chain and has the best growth outlook it has had in the last five years. We find the recent price move strange.

Elsewhere, the only other negative of note in June were the share price falls in the Fund's four most UK consumer-exposed stocks – **Majestic Wine, Restaurant Group, Lloyds Banking Group and Marks & Spencer** – prompted by a profit warning from DFS mid-month and by the general UK uncertainty. As we stated earlier, the Fund's consumer services stocks were a positive contributor to performance over the quarter. As we look forward, we need to be conscious of two things: firstly, the prevailing negative opinion towards the UK and the UK consumer, which will likely lead to indiscriminate selling of such names as investors run scared; and, secondly, that we should sit ready to act in the event of any material dislocations in share price and therefore valuations. The Fund's exposure to UK earnings (80-100% of profits from the UK) stood at c. 22% at quarter end. This is marginally higher than the previous quarter end. The largest shift has been a decision to exit **Sky** and re-allocate over the quarter to larger positions in both The Restaurant Group (2% active) and Marks & Spencer (c.1.1% active), both of which represent idiosyncratic transformation stories at compelling valuations (as detailed in last month's 'Under the Bonnet').

We will sign off with a paragraph lifted directly from the very recent (5th July) Persimmon trading statement. We don't own the stock, but it proves that it isn't all doom and gloom out there:

"We have continued to experience good levels of customer demand since the Group's AGM trading update on 27 April 2017, with the market taking the snap UK General Election in its stride. Consumer confidence remains resilient and compelling mortgage rates continue to offer good support to new home buyers. Group sales through May and June were healthy, leaving our weekly private sales rate per site for the first half c. 7% ahead of last year at 0.80 (2016: 0.75)."