SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

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This document is intended for professional investors only

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2017 Investment outlook

My job is to predict the future. This makes it fun as well as challenging. Some future events are very likely and thus easy to predict. You're never going to make much money betting that the sun is going to rise tomorrow – only an idiot would offer you odds!

Where you will make money is when there is a difference between your perceived chance of an event occurring and the market's perceived chance. If you were an astronomer and spotted an asteroid hurtling to earth you may well make money betting against the sun rising, though of course you wouldn't have much to spend it on if you won! The difference between your odds and the market's odds is known as 'edge' and in the financial world it is the basis of good investment performance.

What makes something predictable is whether it exhibits pattern as opposed to noise. Coin tosses are noisy, as one toss is not influenced by the previous toss. The swing of a pendulum on the other hand exhibits pattern – the time of one swing – also known as the period - is the same as that of the previous swing.

Interestingly, pattern and noise can live side by side, or indeed be part of the same thing. A tiny section of a photograph looks and is chaotic. Zoom out and a picture – a pattern - emerges. Zoom in and you'll see the pattern of molecular structure. In other words, whether you see pattern depends on your perspective. Like the photograph, stock prices tend to exhibit pattern over very short time frames and over long ones, and are essentially noisy in between. Your perspective will determine whether you are able to profit from investment markets on a repeatable basis.

At Seneca, we have a long-term perspective, whether with respect to asset allocation, stock selection or fund selection. We allocate our team responsibilities in terms of the areas in which we are seeking to add value to our portfolios through active management decisions. Mark picks our UK equities, Tom our overseas equities funds, Alan our fixed income investments, and Rich our specialist assets. As for me, I do asset allocation. It is very much a team effort, with each member responsible in some way for the performance of each of our funds.

As asset allocation specialist, the main pattern that I continue to focus on is the relationship between business cycles and financial asset prices. What this pattern is telling me now is that in general you need to avoid safe haven bonds but that you can continue to enjoy decent returns from equities.

Why do I think this?

The business cycle has four phases or regimes: recovery, expansion, peak and recession. According to the National Bureau of Economic Research (NBER), the typical business cycle lasts around 6 years, with the recession phase lasting around 1 year. Business cycles can most easily be discerned in employment statistics. As can be seen in Chart 1, the increases and decreases in the unemployment rate in the US are fairly regular.

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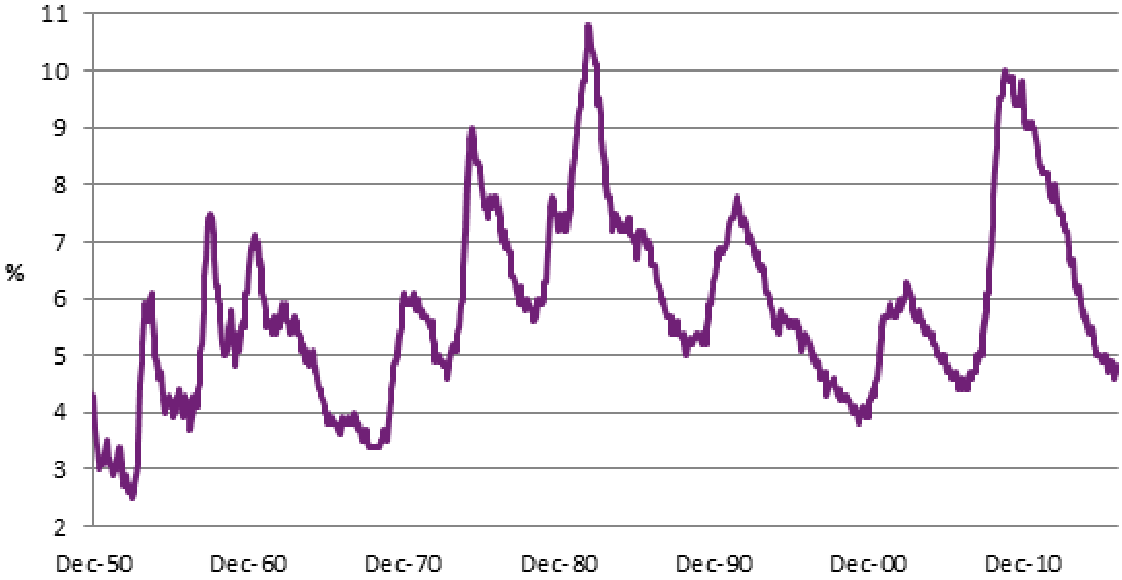
Multi-Asset Value Investing

Why is this?

Following a recession in which businesses shed labour, they will at some point start to rehire. This is the recovery phase, during which monetary policy remains stimulatory and inflation pressures are subdued. At some point, hiring reaches the point at which upward wage pressures become more pronounced. This is the expansion phase, in which inflation rises and central banks start to tighten monetary policy. The peak phase sees economic growth fall - as tight monetary policy starts to bite - but remain positive. This is followed by recession in which businesses shed labour and growth is negative.

Chart 1 U-3 US Unemployment Rate Total in Labour Force Seasonally Adjusted



Source: Bloomberg

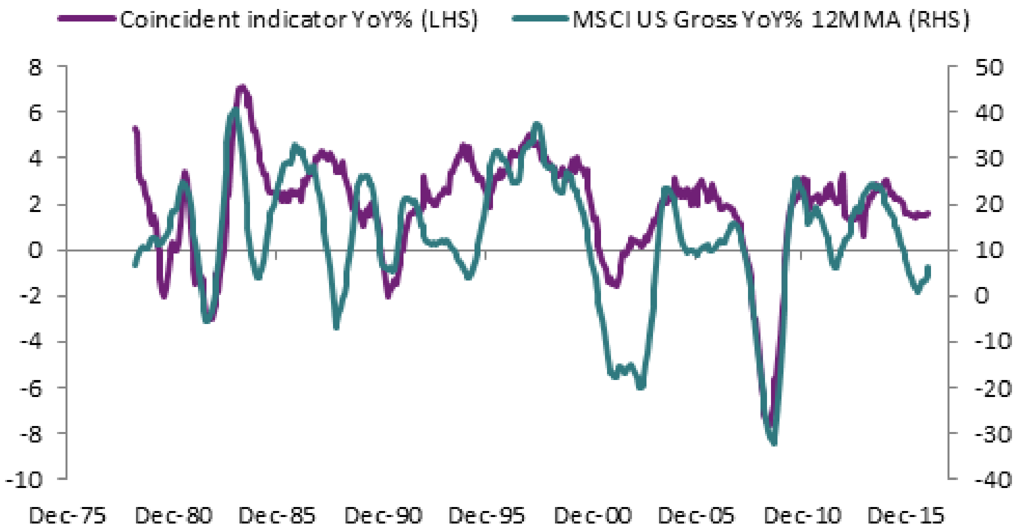
In reality, the phases are not quite as neat as I have described them above. No two business cycles are the same. And some business cycles see prevailing economic conditions move back and forth between, say, recovery and expansion before progressing further. There may also be other non-coincident cycles relating to demographics, wealth inequality or debt that have some sort of influence on business cycles.

Nevertheless, if financial markets were efficient they would anticipate the various phases of a particular business cycle, exhibiting similar real returns in each. This is clearly not the case, evidenced by the well-established pattern of bull and bear markets in both bonds and equities.

The question is whether there is a pattern – a relationship – between the performance of equities and bonds on the one hand and the business cycle on the other. If there is, the asset allocator can have an edge.

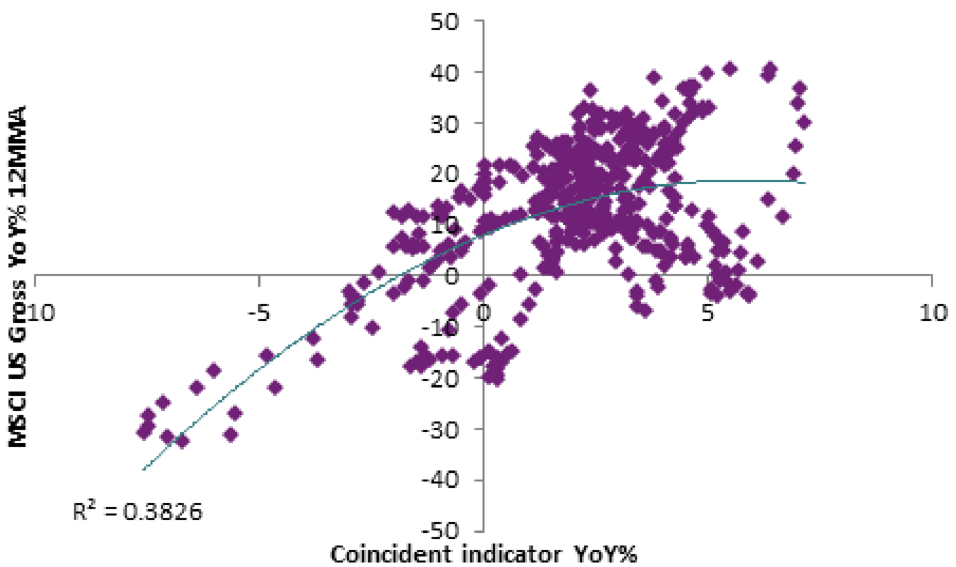
As far as equities are concerned, the answer is a resounding 'yes'. Chart 2 below shows the 1 year performance of US equities against the year-on-year change in the Conference Board's coincident indicator (the generally accepted business cycle indicator). It is not a perfect correlation by any means, but Chart 3 shows that it is significant, with a relatively high R-squared of 0.38 (Note: R-squared is a measure of correlation between two series of numbers. An R-squared of 1 represents perfect correlation, while 0 represents no correlation whatsoever).

Chart 2: US equities versus the US coincident indicator



Source: Bloomberg

Chart 3: How strong is the relationship between the US equities and the US business cycle?



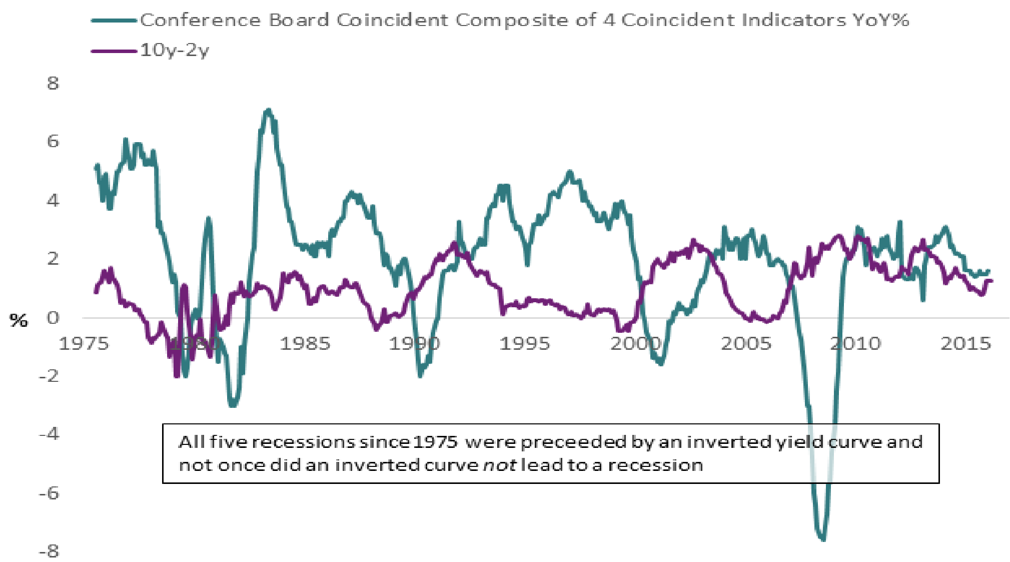
Source: Bloomberg

If there is a strong correlation between equities and the business cycle, the next question to ask is whether there is an indicator which helps us to anticipate inflection points in the business cycle, namely the start of recessions and expansions. Once again, the answer is 'yes, there is'.

Chart 4 below shows the yield curve (10 year minus 2 year) versus the year-on-year % change in the coincident indicator. Although the end of the 70s and early 80s were very turbulent, one can see that there was a "double dip" recession and that these were preceded by inverted yield curves (the middle of 1980 saw the yield curve steepen but not for long, and the 1982 recession followed soon after). The other three recessions since the early 80s (in 1991, 2001 and 2009) were all preceded by negative yield curves, with the lead time being around 2 years. Furthermore, there was no instance of a negative yield curve not leading to a recession.

In other words, we have a way of anticipating recessions and thus a way of predicting equity markets.

Chart 4: Yield curve versus the business cycle



Source: Bloomberg

So, what is the yield curve in the US telling us now about the prospects for the US economy and thus stock prices? Chart 4 above shows that although the yield curve is shallower than it was following the 2009 recession, it is nonetheless still positive. Furthermore, following the recent rise in long-term bond yields, the 10y-2y has moved from 0.8%pts in the third quarter last year to 1.2%pts currently. While not a huge move, this is indicative of an improvement in US economic prospects.

The astute observer will now ask why, if we are sanguine about economic prospects in the US, we are not overweight US equities. The answer is that we are more positive about equities elsewhere, notably Europe where the business cycle, as evidenced by the unemployment rate, is still in recovery phase (a phase when equities tend to perform better than in expansion phase). In other words, our US equity underweight is a relative call not an absolute one.

As for safe haven bonds, particularly those in the US, they tend to perform poorly during expansion phases. This makes complete sense of course given that expansion phases are ones in which inflation rises. I don't need to tell you that rising inflation is negative for bonds.

Current fund targets

The target weights in the table below are where funds should be positioned currently. Actual positions may deviate slightly from these target weights as a result of market movements or ongoing trades for example.

Table 1: Current fund tactical asset allocation (TAA) target weights as of 31 January 2017 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	**26.5** (25.5)	**24.0** (23.0)	**33.0** (31.5)
	North America	0.0 (0.0)	4.0 (4.0)	2.5 (2.5)
	Europe ex UK	**7.0** (8.0)	**10.0** (11.0)	**9.0** (10.0)
	Japan	1.0 (1.0)	8.0 (8.0)	4.5 (4.5)
	Asia Pacific ex Japan	5.5 (5.5)	10.5 (10.5)	9.5 (9.5)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.0 (2.0)	2.0 (2.0)	1.5 (1.5)
	Equities Subtotal	**43.0 (43.0)**	**63.0 (63.0)**	**63.0** **(62.5)**
Fixed income	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.0 (5.0)	2.0 (2.0)	1.5 (1.5)
	Corporate	25.0 (25.0)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**30.0 (30.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets*	Property	**5.5** (5.4)	**5.5** (5.4)	**5.8** (5.6)
	Private equity	4.0 (4.0)	4.5 (4.5)	**5.4** (5.3)
	Specialist financial	**9.3** (9.7)	**8.1** (9.7)	**10.2** (10.8)
	Infrastructure	**5.0** (4.9)	**4.7** (4.4)	**5.4** (5.3)
	Specialist Subtotal	**23.8** **(24.0)**	**22.8** **(24.0)**	**26.8** **(27.0)**
Cash		**3.2** (3.0)	**4.2** (3.0)	**3.2** (3.5)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 31 January 2017

* Target weights for the specialist assets subsectors are the aggregate of holding level targets as top down driven asset allocation targets are not applied to this sector.

Increased ***Decreased***

General

- The US dollar declined sharply in January and ended the month around 4% below its late December high
- The fall was attributed largely to US politics which saw newly crowned president Donald Trump follow through on some of his controversial campaign promises in relation to immigration
- Inflation expectations continued to rise, particularly in the UK
- The funds remain overweight equities, though we did shift targets away slightly from Europe ex UK to UK in light of sterling's decline since Brexit as well as concerns about EU politics
- BT Group shocked the market by revealing false accounting practises within their Italian business. We felt the sharp share price fall was an overreaction, given that this should be an isolated issue and took the opportunity to add to the holding at a yield close to 5%

SDIF
- The holding in One Savings Bank was added to on price weakness to build the position to its full target weighting
- Emerging market debt exposure was increased with a further purchase of the Templeton Emerging Markets Bond Fund

SDGF
- Invesco Perpetual European Equity Income Fund was reduced, following a decrease in the tactical asset allocation for European equities
- Ranger Direct Lending Fund was reduced, due to concerns over the operation of one of the lending platforms used by the company
- Position in International Public Partnerships was increased. The holding provides an attractive inflation linked income stream

SIGT
- European Assets Trust, Invesco Perpetual European Equity Income Fund and Liontrust European Enhanced Income Fund were reduced, following a decrease in the tactical asset allocation for European equities