Stratton Street UCITS - Renminbi Bond Fund UI

August 2015

- **Global growth concerns, economic softness in China and timing of US rate hike led to a volatile month**
- **China modified the renminbi fixing mechanism to a more market driven methodology**
- **US economy showing signs of recovery, but inflation remains lackluster**
- **September "lift-off" remains "live", but futures market pricing in only 38% chance**
- **China has the firepower to boost its economy**

Market Comment

Global growth concerns, perceived economic weakness in China and the timing of the first US rate rise all took market focus in what was a very volatile August. Equity markets sold-off sharply during the month, the S&P index fell -6.3%, into negative territory year to date and the Vix (volatility) Index ended the month at 28.43, having spiked as high as 53.29 intra-day on China's "Black Monday"; which saw global equities nosedive. Commodities continued their rout, but rebounded in the final days of the month. Having dipped as low as $42.23, Brent crude had a last minute rebound in the final three days of trading - off the news that supply had actually fallen in June, from April's peak - crude gained 3.7% on the month, however, we expect global demand to remain suppressed going forward. All of the above sent shivers through emerging markets with many currencies falling sharply; the Turkish lira, for example, fell 5.2%. The yield on the ten-year US Treasury was pretty flat over the month at 2.22%, however, it did swing about somewhat during the month, falling as low as 1.9% intraday on Black Monday.

China was the main story last month as the People's Bank of China (PBoC) announced the "one-off" managed "devaluation" of the onshore renminbi, using its fixing mechanism. The central bank devalued the renminbi fixing rate over three sequential days by a total of 4.5%. Shocked markets interpreted the change in exchange rate policy as being one aimed at gaining export competitiveness; however, we maintain that the central bank's motivation was more to do with the potential inclusion of the renminbi in the IMF's SDR basket. One of the criticisms of China's foreign exchange policy is that the exchange rate is not driven by market forces. Until recently, the central bank has set the fixing each day around which the renminbi can float in a band of +/-2%; now the fixing is based more on market pricing. To facilitate this change the PBoC needed to move the fixing to the (lower) market rate, this move created market uncertainty, but stability returned to the onshore currency which was only 2.8% lower on the month.

Elsewhere, the US economy has been showing further signs of improvement, although still a mixed picture. The second reading for Q2 GDP was released above-expectations at 3.7%, up from 2.3%. The housing market has been recovering, job creation is on the up - although wage acceleration remains tepid. But, on the flipside we have low crude prices, uncertainties on the inflation picture and a strong dollar which is up over 6% so far this year (measured by the DXY index) or 8% if we use the Fed's preferred trade weighted dollar index (TWDI). Dovish Fedspeak seemed to temper markets slightly as New York Fed President, Bill Dudley commented that a September rate hike "now seems less compelling" with Atlanta Fed President, Dennis Lockhart adding that falling oil prices and wobbly financial markets are "complicating" the Fed's outlook. Futures markets were quick to react; the probability of a rate rise in September shifted markedly lower from roughly 55% earlier in August to ~38% by month-end.

Historical Performance[1]

	2015 %	* Inception %
IDUSD Class	0.79	3.41
IDGBP Class	1.59	5.45
IDEUR Class	0.95	6.43
IDCNH Class	4.70	10.27
ODGBP Class	-0.68	1.21

Performance Summary[1]

Index	Monthly Return %
Renminbi Bond Fund UI (Inst USD Class)	-5.34
HSBC China Offshore Renminbi bond index (USD)	-5.52
Offshore Chinese Renminbi (CNH)	-3.44

Fund Prices[1]

Institutional Class	Price	Monthly Return %
USD	99.60	-5.34
GBP	99.80	-4.63
EUR	100.63	-5.37
CNH	106.28	-1.58
Ordinary Class	**Price**	**Monthly Return %**
GBP	100.66	-5.54

Portfolio Statistics

Gross Redemption Yield	4.89%
Gross Running Yield	4.94%
Fund NAV (USD Millions)	20.78
Number of holdings	32
Number of countries	8
Duration	7.61

Fund Breakdown

Net Foreign Assets		Entity Type	
Rating	% NAV	Entity	% NAV
7 Star	51.88	Sovereign	8.56
6 Star	23.32	Quasi	63.77
4 Star	17.44	Corporate	20.31
3 Star	4.59	Supra	4.59
Total	97.23	Total	97.23

Credit Rating		Region	
Rating	% NAV	Region	% NAV
Aa	42.77	Asia Pacific	39.17
A	30.13	C&W Asia	17.44
Baa	24.33	Middle East	40.62
Total	97.23	Total	97.23

Portfolio Exposure by Country	% NAV
Abu Dhabi	6.68
China	23.32
Hong Kong	14.36
Kazakhstan	4.59
Qatar	24.67
Russia	17.44
Saudi Arabia	4.69
Singapore	1.48
Total	97.23

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Fed vice-chair Stan Fischer said, at the Jackson hole gathering, that he expects inflation to pick-up and that policy change needs to be pre-emptive adding that although the Fed is set to tighten, uncertainty remains on timing, but September remains “live”. There seems to be a clear divide in opinion not only within the Fed, but also the wider investment community, so much so that some are calling for another round of quantitative easing; “QE4”. Former Treasury Secretary, Lawrence Summers wrote in an opinion piece in the Financial Times, “a reasonable assessment of current conditions suggest that raising rates in the near future would be a serious error that could threaten all three of the Fed’s major objectives - price stability, full employment and financial stability.” QE4 is something we have discussed in-house, however, we believe that this would be a last resort measure, not only does the post-QE-fueled economy need to adjust to an equilibrium, but the last thing the Fed needs is a backlash of criticism and potential political risks.

Portfolio Review

The Fund’s USD I class was down -5.34% while the HSBC Offshore Renminbi Bond Index fell -5.52%. The major weight on performance came from the short-term fall in renminbi over the month, after policymakers moved the peg lower against the dollar.

The best performing holdings came from Qatar sovereign issues, which have also been some of the best performing holdings so far this year. Rated Aa2, the issues maturing in 2040 and 2042 tightened 10 and 13 basis points in August. The bonds continue to offer attractive risk-adjusted returns; if the 2040 issue, which ended the month trading at a spread of 157 basis points over Treasuries, was to trade at fair value, we would expect a return of 14% (price and yield).

Elsewhere, holdings in Asia and Russia gave some performance back as a result of the emerging market turbulence. We are very comfortable with the current portfolio which has: 32 holdings of which 77% of the holdings are sovereign or quasi-sovereign issues, a high weighted average credit rating of A3 and yield of ~5%.

Outlook

Concerns have been raised about the future of the renminbi after the recent intervention in both the Chinese equity market and the currency fixing mechanism. There has also been a slew of weaker data points out of China in the past couple of months which has added to market turbulence and the risk-off environment.

Unlike many other countries, Chinese authorities have the firepower which they can deploy to battle such events. Take the recent cut in benchmark interest rates, both deposit and lending rates were trimmed by 25 basis points, which have made it easier to take out loans. There was also a 50 basis point cut to banks’ required reserve ratio, which by international standards are already extremely high at 18%; suggesting the PBoC has considerable policy flexibility going forward. Add to this the huge foreign currency reserves, which were at USD 3.65tn ahead of the change in currency regime. Some estimates suggest that roughly USD 100bn has been spent defending the currency during the risk-off environment. However, China’s trade surplus, which has averaged over USD 40bn a month so far this year, is at a record high.

Meanwhile, the Chinese government is striving to rebalance the economy away from an export driven one, towards a consumer and service economy. The reasons for this are relatively straightforward. China’s savings rate is just under 50% which provides plenty of scope to boost GDP by encouraging greater domestic consumption. The shift away from an export led focus is also aided by an appreciation of the renminbi as this provides greater spending power to consume goods produced abroad.

We believe that the short-run weakness in the renminbi provides an excellent entry level for investors who are underweight the currency. The renminbi is already the fifth most actively traded currency in the world and should become a major reserve currency at some point over the next few years, aided by its potential inclusion in the IMF’s SDR basket. Investors are significantly underweight Chinese assets owing to the lack of inclusion in many major indices currently. With Chinese interest rates roughly 2-3% higher than those in the US, a stable renminbi equates to gains in US dollar terms from holding renminbi.

Share class information

Institutional	Current AMC	Minimum Subscription	Subsequent Investment	Front-end load	SEDOL	ISIN	Bloomberg
ID EUR	1%	EUR 100,000	EUR 10,000	None	5078151	LU0850781518	STRBIDE LX
ID USD	1%	USD 100,000	USD 10,000	None	5078175	LU0850781781	STRBIDU LX
ID CNH	1%	USD 100,000	USD 10,000	None	5078186	LU0850781864	STIDCNH LX
ID GBP	1%	GBP 100,000	GBP 10,000	None	5078208	LU0850782086	STRBIDG LX
ID GBP ACC	1%	GBP 100,000	GBP 10,000	None	BVJDP45	LU1163072603	TBC
ID CHF	1%	CHF 100,000	CHF 10,000	None	5078216	LU0850782169	TBC

Ordinary	Current AMC	Minimum Subscription	Subsequent Investment	Front-end load	SEDOL	ISIN	Bloomberg
OD GBP	1.5%	No minimum	No minimum	Up to 3%	5078275	LU0850782755	STRODGB LX
OD EUR	1.5%	No minimum	No minimum	Up to 3%	5078224	LU0850782243	STRBODE LX
OD USD	1.5%	No minimum	No minimum	Up to 3%	5078259	LU0850782599	TBC
OD CNH	1.5%	No minimum	No minimum	Up to 3%	5078267	LU0850782672	TBC
OD CHF	1.5%	No minimum	No minimum	Up to 3%	5078291	LU0850782912	TBC

Classes in red signify currently inactive but available on demand.

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Fund Information

Domicile / legal status:	Luxembourg / SICAV (UCITS)
Base currency of the Fund:	USD
Valuation currency:	USD, EUR, GBP, CHF or CNH (depending on share class)
Valuation/dealing:	On every full banking day, which is simultaneously a stock exchange day in Luxembourg, United Kingdom and Frankfurt am Main.
Subscription/withdrawal:	Prior business day by 4pm (Lux time)
Appropriation of earnings:	Distributing (all share classes)
Investment manager fee:	For share classes "I" and "O": up to 1.70% p.a. of the net asset value of the share class. See table above for current annual management charge (AMC).
Management company fee:	For share classes "I" and "O": up to 0.30 % p.a. of the net asset value of the Sub-Fund subject to min. EUR 45.000.- p.a. for up to 2 share classes; for additional share classes the Management Company receives additional min. 7.500.- p.a.
Other fees:	Custodian and Paying Agency Fee, Domiciliary and Corporate Agency Services Fee, Registrar and Transfer Agency Fee: up to 0.10% p.a. of the Sub-Fund's net asset value, min. up to € 40.000 p.a. subject to Luxembourgish VAT.
Front-end load:	For share classes "OD USD", "OD CNH", "OD GBP" and "OD CHF" up to 3%. There is no front-end load currently applicable for share classes "ID EUR", "ID USD", "ID CNH", "ID GBP", "ID GBP ACC" and "ID CHF".
Redemption fee:	None
The Company:	Stratton Street UCITS
Name of the Sub-Fund:	Stratton Street UCITS - Renminbi Bond Fund UI
Asset Manager:	Stratton Street Capital LLP
Management Company:	Universal-Investment-Luxembourg S.A.
Auditors:	KPMG Luxembourg
Custodian:	Brown Brothers Harriman S.C.A.
Planned distribution countries:	UK, Austria, Germany, Switzerland, France, Belgium, Netherlands, Sweden and Luxembourg
*** Launch Dates:**	01 October 2013: IDEUR launched 21 October 2013: IDUSD launched 31 October 2013: IDGBP launched 28 November 2013: IDCNH launched 16 April 2014: ODGBP launched
Footnotes:	1. Bloomberg (as at end of month)

Platforms and providers

Stratton Street UCITS - Renminbi Bond Fund UI can be accessed via the following platforms and providers:

Aegon	AJ Bell/SIPP Centre
Ascentric	AXA Isle of Man
Canada Life International	Cofunds
Friends Provident Isle of Man	Legal & General
Novia	Royal Skandia
Transact	Seven Investment Management (7IM)
UBS Funds Centre	

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