LOM OFFSHORE FINANCIAL SERVICES

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Weekly Global Market Commentary
November 16th, 2016

The Trump Bump and Financial Services - By Bryan Dooley, CFA

With the U.S. election in the rear view mirror, investors are looking ahead to the December Fed meeting where futures markets suggest another rate hike. The likelihood of a rate increase on top of the Republican party sweep has recently tumbled the prices of longer term bonds and interest-sensitive equities including real estate investment trusts (REIT's) and utilities. However, the broader S&P 500 stock index has been soaring since the day after the election, led by non-REIT financial stocks. Some industries are expected to benefit from potentially higher yields.

Financial services equities have been outperforming the overall stock market on hopes that higher rates will allow financial institutions to begin earning better returns on their capital. Banks are often cited as potential beneficiaries of a steeper yield curve which should improve net interest margins, an important profitability component. Less regulation of the financial sector is also seen as a constructive windfall from the Republican party.

Besides banks, insurance and reinsurance companies may also gain. Insurers like to play the 'float' by investing customer premiums until they are required to meet claims. Better times may lie ahead, but interest rates still remain historically low and future increases, though perhaps now more assured, will likely come very slowly. Meanwhile, the industry remains highly competitive on price and growth is slow. Investors should remain cautious and selective on insurance shares.

Reinsurance, a key sector for the Bermuda economy, faces substantial headwinds in the years ahead as views of expected returns suggest an eroding profit outlook for the industry. The October landfall of hurricane Matthew caused significant property damages but pricing remains a challenge and lower interest rates continue to pressure investment earnings. However, more nimble players may have room to make headway and merger activity has been strong.

Expected returns inform pricing decisions and are derived from industry acumen, experience and proprietary models. Unlike primary insurers, where major losses are often excluded from underlying margins, managing catastrophic loss is a required core competency for reinsurers.

Industry profits were helped by the lack of major loss events in 2014 and 2015, but a second quarter decline in actual returns followed lower expected returns this year. Analysts believe lower premium rates and a warmer climate could further trouble global reinsurers if hurricane activity picks up following subdued action in recent years. Florida has not had serious hurricane since 2005 and the fading effects of El Nino raise the odds of a major storm.

Recently, Bermuda-based Renaissance Re warned of lower returns for the industry reflecting a recent influx of new capital. Morgan Stanley downgrade Ren Re last quarter citing interest rate pressure and lower return-on-equity expectations. Risk-adjusted pricing for property catastrophe reinsurance is the lowest in fifteen years and contract terms are less strict according the report.

Some reinsurers are tackling the low rate environment by taking a more aggressive position on the investment portfolio. Indeed, Warren Buffett attributes a good deal of his fortune to more aggressively investing the float earned from his insurance operations. Some reinsurers are trying to follow suit by looking to higher risk and less conventional investments for a portion of their investments.

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Axis Capital, another local reinsurer reported strong third quarter results which were mainly driven by a 154% surge in investment income. In 3Q, investment income more than doubled to $117 million and most of this growth was attributable to a $65 million increase in the value of the company's alternative investments, including hedge funds. Still, this $847 million portfolio is relatively small at 6% of the total investment portfolio.

Other reinsurers are looking for revenue growth on the underwriting side through more innovative strategies. Privately-held Scor Reinsurance cites opportunities in emerging markets and insuring new risks such as cyber attacks and solar storms.

Reinsurers have found an easy path to creating shareholder value is through merger and acquisition activity. Combining operations and slashing costs is one way to produce bottom line results. Recent tie-ups between Partner Re and Exor, Endurance and Montpelier Re and others make this clear.

Investors may benefit from further M & A activity or by staying with those companies showing innovative strength and focusing on niche markets. On the plus side, most reinsurance companies are now well capitalized and have a history of paying attractive dividends.

Preferred shares of the strongest reinsurers offer an interesting alternative, too. Preferred stock dividends from European and Bermuda companies are generally exempt from offshore withholding and typically offer coupons in the five to seven percent range. Because preferred shares have relatively low liquidity and unique call features, (which have the potential to wipe out returns) investors should possess extensive knowledge of the hybrid market or employ a professional in this space. The top-ranked LOM Stable Income Fund provides actively managed exposure to this sector.

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Stock Market Performance

	11/11/16	W-o-W	M-o-M	Y-o-Y
DJIA	18,848	5.4%	4.0%	6.5%
S&P 500	2,164	3.8%	1.3%	4.3%
MSCI World	1,697	2.2%	-0.2%	0.3%
S&P/TSX	14,555	0.3%	0.0%	9.1%
BSX	1,636	-0.2%	1.3%	27.5%
FTSE100	6,730	0.6%	-4.8%	6.9%
DAX	10,668	4.0%	0.9%	-2.2%
CAC	4,489	2.6%	0.4%	-9.4%
Nikkei	17,375	2.8%	2.1%	-11.8%
Hang Seng	22,531	-0.5%	-4.3%	0.8%
Shanghai	3,196	2.3%	4.3%	-12.4%

Key Rates and Prices

Currencies	11/11/16	Month ago	Year ago
EUR	$1.09	$1.11	$1.07
GBP	$1.26	$1.21	$1.52
JPY	¥106.65	¥103.51	¥122.86
CAD	$0.74	$0.75	$0.75
CHF	$1.01	$1.01	$1.00
AUD	$0.75	$0.75	$0.71
Fixed Income			
3M LIBOR	0.91	0.88	0.36
3M Treasury Bill	0.47	0.33	0.13
2Yr Treasury Note	0.92	0.87	0.88
10Yr Treasury Note	2.15	1.77	2.33
Fed Funds Rate	0.50	0.50	0.25
Commodities			
Gold/oz.	1,227.85	1,252.73	1,086.32
Silver/oz.	17.38	17.46	14.33
Copper/lb.	2.52	2.18	2.24
Oil	43.41	50.79	42.93

Global Economic Calendar (November 14th– November 18th)

Mon: Industrial Production (EMU), Producer & Import Price Index (SWISS)
Tue: GDP Flash (GER), CPI (FR), CPI, Producer Price Index (GB), GDP Flash, Merchandise Trade (EMU), Retail Sales, Empire State Mfg Survey, Import & Export Prices, Business Inventories (US)
Wed: Labour Market Report (GB), PPI-FD, Industrial Production, Housing Market Index, EIA Petroleum Status Report, Treasury International Capital (US), Manufacturing Sales (CAD)
Thurs: Retail Sales (GB), HICP, ECB Minutes (EMU), Consumer Price Index, Housing Starts, Jobless Claims (US)
Fri: PPI (GER), CPI (CAD)

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