# Market commentary April 2016

## Brief overview

"The time has come for politicians to join the fight alongside central bankers".
The Economist magazine, 20th February 2016.

After seven years at near zero interest rates, the United States Federal Reserve (the Fed) finally decided to raise rates by 0.25% at its December meeting. The Chairwoman, Janet Yellen stated that keeping interest rates near zero for much longer would have created an undesirable risk that inflation would eventually overshoot their target resulting in much steeper rate rises later on. Given the considerable sensitivity surrounding the decision, the outcome could be described as successful with an initial modest move in asset prices and the Dollar.

There is no escaping the fact that the financial crisis has had an extended effect on global growth as we approach the sixth consecutive year of sub-par, global economic performance. The International Monetary Fund (IMF) produce the most comprehensive set of assessments of the world economy and they are currently forecasting annual growth of 3.2% p.a. for 2016. This is too low for policymakers as the recovery remains too fragile with rising risks and a meeting of the G20 in Washington urged countries to increase co-operation and do more to support fiscal policy (tax and spending).

As growth and inflation has continued to disappoint (too low in both cases), central banks are under increasing pressure to add further monetary stimulus and Negative Interest Rate Policy (NIRP) has been introduced as the latest unorthodox policy tool. The reduction of the base lending rate to below zero. In theory, it dis-incentivises saving and boosts consumption and investment but it reduces bank profitability, evident in the recent crash of European bank shares which are down as much as 50% in some cases.

The economies of Europe and Japan are at the epi-centre of this policy. Mario Draghi, the head of the European Central Bank (ECB) recently announced a further interest rate cut to -0.4% which followed the Bank of Japan's (BOJ) surprise announcement in January to take interest rates into negative territory. The Japanese equity market fell significantly as the long term credibility of the policy came under scrutiny. It appears at this juncture, that we may have quickly reached the end of NIRP given the extreme distortions that it creates in markets but it has left central bankers with a challenge to effectively close Pandora's Box.

In February, the UK Prime Minister David Cameron announced June 23rd as the date for the Brexit referendum. The most noticeable impact on UK financial markets was the fall in Sterling against the Dollar as the exchange rate briefly fell below the psychological level of 1.39 dollars to the pound. Companies and investors raised their hedging activity to elevated levels not seen since 2010 in order to protect their investments against further falls in Sterling, should a vote to leave the European Union come to pass. Pressure on Sterling has been building for some time before the announcement given the large current account deficit but has since recovered some of the losses. Its future path is dependent upon the outcome of the June vote.

Brent crude oil slumped to a new low at circa $25 a barrel before rallying to the mid $40s by April. Oil was trading as high as $110 in July 2014 and the loss of revenue has had a severe impact on the oil majors, the U.S. shale oil industry and on the major exporting nations such as Saudi Arabia, Russia and Venezuela. Other raw materials such as copper, gold and iron ore also rallied from their early year lows.

**UK equities** FTSE All Share Index -1.8%

The UK economy grew by +2.2% in 2015 and continues to recover modestly. Economic forecasts suggest a slowdown in 2016 (+1.9%) and 2017 (+1.6%) caused by the resumption of government austerity efforts and the uncertainty to investment plans over Brexit. Household spending continues to be the main contributor to growth whilst government spending has remained largely flat. Conversely, the inflation forecast is far more uncertain. There are downside risks from lower food and energy prices whilst a Brexit vote will likely lead to a sharp depreciation in the value of Sterling and raise inflationary expectations accordingly. The Bank of England has consistently pushed the chance of interest rate rises further down the line and the forecast for rates is still unclear with one or two small rate rises by the end of 2017 remaining the central case.

Despite experiencing considerable volatility entering the New Year, the UK stockmarket is mildly positive (FTSE All-Share Index +0.5%) on a total return basis, year to date. Oil equipment and service companies have suffered heavy losses as the oil majors scaled back on investment plans and new development projects. Mining companies sold-off sharply at the beginning of the year due to declining raw material prices as the multi-year bear market in commodities continued to rout shares. UK banks performed poorly as a combination of low interest rates tightening their profit margins and the litany of historical compensation payments for past misdemeanours has caused further profit write-downs.

'Disruptive technology' has become a buzzword in investment circles with innovative new technologies destroying the economics of mature industries. Amazon's assault on the retail sector, the digitalisation of newspapers and the rise of Uber and Netflix has led to the start-up legend Marc Andreeson declaring that 'software is eating the world'. Other industries such as biotechnology, genome sequencing, energy, electric cars, battery storage and banking payment systems are all spurring technological change. The sector containing 'software and computer services' performed strongly in the period under review.

The UK payout ratio, the percentage of profits paid out as dividends, has risen sharply in recent years to over 70%. The median level of payout over the last 45 years has been closer to 46%. We have already seen a number of high profile dividend cuts at Rolls Royce with its first reduction in 25 years and Rio Tinto, whilst companies like Shell continue to fund their dividends in the short-term out of reserves. Unless growth returns, we are likely to see more dividend cuts affecting dividend yields from some of our largest companies.

**International equities** FTSE All World (ex UK) Index +8.1%

Christine Lagarde, Managing Director, IMF, 5 April 2016 stated "the good news is that the recovery continues; we have growth; we are not in a crisis. The not-so-good news is that the recovery remains too slow, too fragile, and risks to its durability are increasing."

The S&P 500 returned +4.1% and the dollar appreciated against the pound by +8% enhancing the return to UK investors. The US household sector continues to de-lever, a trend that has been in place since the financial crisis whilst public sector debt remains stubbornly above the 100% debt to gross domestic product (GDP) level. Total business sales in the US have been rolling over for a year or so now and past cycles of this nature usually indicate an impending recession. Likewise, profits across the whole of the US economy have continued to fall since 2014 making the move up in US markets look unsustainable. Profit margins which have stood at record high levels not seen since the 1950's are now in decline due to persistent real wage rises on the labour side.

Company valuations (on a P/E basis) have continued to break-out to higher levels and remain elevated from a historical perspective suggesting lower projected returns in the future. These risks to the economy have allowed Janet Yellen, Fed Chairwoman, to step back from her original plan of four U.S. interest rate rises in 2016 to something closer to two rate rises and the Dollar has since weakened accordingly.

The FTSE Europe (ex UK) Index returned -7.0%. The euro appreciated against the pound by +8.8% enhancing returns to UK investors. Economic growth in the Eurozone remained remarkably steady in 2015 and is forecast to grow at +1.4% in 2016 and +1.6% in 2017. Spain continues to set the pace for the rest of the monetary union as it posted another quarter of 0.8% growth. France and Italy are growing at anaemic levels whilst the Greek economy is still contracting. Eurozone inflation is very close to zero and deflation remains a real threat.

Mario Draghi's Negative Interest Rate Policy (NIRP) is designed to stimulate the Eurozone by bringing down bond yields and reducing the cost of borrowing for companies and governments. Germany now has 8 year government bonds yielding -0.04% and Switzerland is quoting negative yielding 10 year bonds at -0.2%. This is the case for the majority of the other major European countries except for the United Kingdom and Norway who still retain positive yielding bonds across all timescales.

China remains a key risk in investors' minds as the economy transitions from high growth export to a slower growth domestic led economic model. Chinese GDP was +6.8% in 2015, roughly in line with the official target of +7%. In recognising the threat to a more severe slowdown, the Chinese government has engaged in a huge stimulus effort which has probably supported commodity prices in the short term. However, the expansion of bank loans in the last two quarters and rising Tier 1 property prices above 30% per annum is somewhat alarming. Bank loans stand at 263% of GDP which is the same level as Spain in 2007. A devaluation of the Renminbi currency appears inevitable at some point, which will have a de-stabilising effect on global markets although the exact timing is difficult to forecast.

The Bank of Japan (BOJ) is venturing into more unorthodox policies through the combination of NIRP and buying equities direct. The BOJ is now reportedly a top 10 shareholder in 90% of companies in the Nikkei 225 Index creating moral hazard. Japanese economic growth is stubbornly low at 0.8% per annum against the backdrop of unprecedented stimulatory policy action over the last 2-3 years. Inflation is a lowly 0.4%. However, the latest move to negative interest rates did not pass without incident as market participants questioned the credibility of the policy. The Yen appreciated sharply against the Dollar by circa +10% and the Japanese equity market sold off heavily. Japan leads the global economy in extraordinary monetary policy measures designed to break the cycle of debt-deflation but it is the determination of the authorities to use all means necessary to exceed their 2% inflation target which keeps investors interested. Many European investors are looking to Japan to see what is becoming increasingly relevant to them.

**Fixed Interest Securities** FTSE British Government All-Stocks Index +4.4%

The ten year UK Gilt yield is +1.5% and the U.S. 10 year Treasury Bond yield is +1.8%. UK Investment grade corporate bonds yield +3.2%. The proliferation of negative yielding government bonds is difficult to comprehend given the thirst for save haven assets. In 2015, the face value of negative yielding assets was $972 billion, in 2016, this number stands at $6.623 trillion. By conventional measures this is a bond bubble of epic proportions that would burst if there were significant interest rate rises. However, there is little sign of that in developed markets as interest rates remain anchored and bonds remain the asset of choice for institutions in a protracted, low interest rate environment.

The experience of Japanese investors over the last 25 years of an ultra-low interest rate environment is that bonds provide low single digit but stable returns. Given that the Japanese stockmarket is still less than half of its value in 1991, one can see the appeal of such an investment strategy.

In the UK corporate bond market, Unilever recently issued a 4 year bond with no coupon. In layman's terms, one can purchase their bond in the open market effectively lending the company money over a 4 year period whilst receiving no interest payments in return. The original capital is returned in 4 years. This is clearly not a compelling investment opportunity and is further evidence of the extreme distortions created by NIRP and ECB bond buying programme in Europe.

**Commercial property** FTSE WMA All UK Property Index +1.8%

Industrial properties returned +5.4%, UK offices +5.0% and retail +2.9%. Investment in central London office buildings dropped by 52% quarter-on-quarter as dealmaking was slowed by nervousness over Britain's vote on membership of the EU. Some £2.2 billion of London offices changed hands in the first quarter of 2016, the lowest level for more than four years. The IPD Index drop in March of -0.6%, was the first monthly fall in 3 years and is the first tentative evidence that capital growth in this sector may be peaking. For the foreseeable future, UK commercial property investments will be an income story. From a technical perspective, there have been some legislative changes to property funds which will prompt more investment funds to convert to PAIF status (Property Authorised Investment Fund) allowing ISAs, pension funds and charities to receive the rental income gross of tax, improving the income yield.

**Alternatives**

Gold and silver miners have performed very strongly since the start of the year whilst bulk commodities have recovered well from the lows of mid-February. Whilst there is not enough evidence to suggest that the industrial commodities can make significant progress from here, precious metal mines trade at bargain basement valuations and could offer further upside. The accounting for 'all-in-cash-costs' has introduced some much needed discipline into the sector and valuations have advanced in response.

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Indices performance statistics are for the period 6th October 2015 to 5th April 2016, total return with income reinvested.
Source of statistics: WMA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.

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