Market commentary **October 2016**

‘There are limits to what monetary policy can and indeed, should do. The burden must fall on fiscal and other policies to do their part to help create conditions conducive to economic stability’
John C Williams, President of the Federal Reserve Bank of San Francisco, Aug 2016

Overview

In June 2016, the UK voted to leave the European Union as angry voters targeted the effects of globalisation, which will likely result in more protectionist policies to insulate workers from the pressures of the global labour market. The protestations of the International Monetary Fund alongside the Bank of England and others will likely be ignored with economists being dismissed as “experts”. Sterling weakened significantly against the Dollar by around -19%, to its lowest level since 1985 and -15% against the Euro. As a precautionary measure, the Bank of England lowered the bank base rate for the first time in seven years to 0.25% and restarted its Quantitative Easing (QE) policies which had remained dormant for some years. Long suffering deposit holders will receive lower savings rates and should be cognisant of higher inflation eroding the real value of their savings over the next few years. Projections will now likely exceed the 2% p.a. target for the Consumer Prices Index (CPI) over the next three years rising from its current 1% to around 2 3/4% in 2018 before gradually falling back in 2019.

In a broader context, global economic growth remains lacklustre at circa 2.3% p.a. but appears stuck at activity almost half of pre-financial crisis levels. There are tentative signs of revival in the emerging markets, most notably in Brazil and India but China is stumbling and remains a key risk to markets. There is evidence of higher wage growth in the United States and core inflation is rising steadily. Inflation remains low in most major economies but there is growing evidence, except in Japan, that it is moving higher.

Whilst we see further interventionist policies by central banks, lower interest rates and QE appear to be having little effect on the real economy. The seismic shift in political events so far in 2016 are in many ways, the catalyst for governments to assume more responsibility for economic growth through fiscal policies namely tax, spending and investment. Voters have essentially questioned the efficacy of post-crisis monetary policies and demand a change in direction. We are at the foothills of the debate about what form ‘fiscal stimulus’ should take but infrastructure and capital investment programmes such as Hinckley Point, HS2 and the third runway are good examples of how the government can intervene to create jobs and growth, albeit against the backdrop of much public debate.

UK equities

FTSE All Share Index 14.8%

The hit to the UK economy has not been as bad as originally thought following the June vote, although it is still likely that growth will slow as we move into 2017. Firms cutting back and delaying investment, given the uncertainty, will ultimately impact on wages and employment. In the immediate wake of the UK referendum decision, there were some volatile reactions in financial markets. After initially dropping below the 6,000 mark, the FTSE 100 recovered surprisingly well as around 79% of the revenues earned from overseas and international companies gained from a ‘one-off’ currency translation effect. It is still premature to conclude that Brexit concerns were unwarranted (Article 50 is yet to be triggered) and UK economic growth is likely to be weak again for 2017 with projections pointing towards 0.8% p.a., well below long-term trends. Large UK companies remain engaged in some bad behaviour with debt levels rising well above their long-term averages and companies are paying out as much as 90% of their profits to shareholders, which is too high. Andy Haldane, Chief Economist at the Bank of England, July 2015 stated that “profits that businesses are earning are not being used to finance investment but instead to finance dividends or the buying back of shares. They are almost eating themselves". Aggregate profits for the constituents of the FTSE All-Share Index have fallen steadily since 2011 to about 70% of their peak but companies remain supported by ultra-low interest rates allowing them to re-finance their debts at historically low levels.

The consumer goods sector (includes drinks, tobacco and builders) has continued to grow and now represents around 17% of the FTSE All-Share in value compared to below 5% in 1999. Investors 'hunting for income' have turned to the stock market to maintain their lifestyles and have invested in large consumer companies such as Unilever, Diageo and British American Tobacco for steady dividends, somewhat higher than the income available on bonds and bank deposits. These so-called 'bond proxies' have risen to very high valuations relative to history and 'low-risk' investors have chosen to ignore the reality that shares still represent risk with potential loss to capital. At some point in the cycle, investors will be reminded that starting valuation is an important component of future returns. Banks have continued to perform poorly as valuations reach all-time lows with profits clipped from mis-selling compensation claims and very low lending margins due to the low interest rate environment.

International equities

FTSE All World (ex UK) Index +7.0%

U.S. economic growth was disappointing in the first half of 2016 rising by just 1% on an annualised basis. The labour market has continued to show steady improvement with unemployment at a post-crisis low of 4.9%. Annual wage rises have reached 3.5% which is pushing up the rate of core inflation. At the beginning of the year, the Federal Reserve were predicting four interest rate rises this year but its looking increasingly likely that it will only be one in December. The quarterly profit numbers for U.S. companies have been falling since mid-June 2014, which has clipped the progress of the U.S. equity markets. There are indications of some improvement in the last three months but valuations still look on the high side from a long-term perspective. There should be some improvement to profits as we move into 2017 although the scale is highly uncertain and analyst predictions tend to be overly optimistic. A weaker Dollar and higher oil price should be supportive whilst higher wages and rising interest rates will crimp corporate profit margins. The outcome of the presidential election has rarely been seen as a defining moment for the economy and society however, this time is different. Whilst Brexit was seen as a vote to allow the UK to engage more broadly on trade with the global economy, the rhetoric of a Trump presidency appears more protectionist although there are some parallels to voters' demands on both sides of the pond.

In Europe, economic growth has slowed to a crawl since the first quarter of this year, disappointing in a familiar fashion to the last three years since the European Debt Crisis. France and Italy reported no economic growth in the second quarter of the year suggesting worsening fortunes. Germany saw moderate growth whilst Spain has been fairly resilient, although unemployment has only just fallen below 20% for the first time since May 2010. Italian banks have been under pressure with a steady uptrend in non-performing loans as both households and companies have struggled to keep up debt repayments. Italy's oldest bank, Banca Monte dei Paschi di Siena has the worst capital position of any European bank and has required support. Italy will need to reform and restructure its bankruptcy laws to alleviate future problems. The Eurozone is likely to grow by 1.6% for 2016 and 1.3% for 2017. Inflation remains stubbornly low at 0.3% which has prompted the European Central Bank (ECB) to cut deposit rates to minus 0.5% in September (yes, below zero!). The ECB has become conscious that its QE programme and negative interest rates is now having virtually no effect on the real economy. Its options to stimulate the economy are fast running out. They may resort to buying equities which would be yet another step into the unknown for the ECB. Political developments continue to have a key role in any assessment of the prospects for the Eurozone. While the long drawn-out nature of Brexit is ever present, pro-EU sentiment has been enhanced in some areas supporting the view that the UK's choice might lead to increasing harmony among the remaining EU nations.

Chinese GDP growth was unchanged in the second quarter at 6.7%, year on year, mainly due to heavy but ultimately unsustainable government stimulus. China has consistently appeared at the top of the International Monetary Fund's 'debt at risk' list but a lack of a trigger event has failed to create any material downturn. House prices are rising by 25% per annum in Beijing and Shanghai as local governments are starting to take action. U.S. imports from China have been on a steady downtrend since 2010 with no sign of abating. Levels of chinese debt have taken-off since 2008 and a debt to GDP ratio of close to 300% justifies its high-risk rating.

In Latin America and Emerging Europe, there are tentative signs that the profit cycle may have finally turned after almost 5 straight years of declines, following stronger commodity prices. Emerging equity markets have correspondingly performed well to the surprise of many investors, although markets have traded well ahead of events at this juncture. Long-term valuations are generally supportive but there is a sense that there are better entry points to increase portfolio allocations. At this late stage of the global economic cycle, it would be surprising if this proved to be a decisive turning point, although it is conceivable that rising commodity prices are front-running higher levels of global inflation.

Although an uncomfortable 'truce' has broken out in the currency wars (countries prefer weakening currencies to boost exports), the yen has been appreciating significantly against the dollar and briefly broke the 100 yen to the dollar mark (from 128 a year ago) in August. Japanese equity markets have struggled accordingly as a strong yen is a considerable headwind to the largely export sensitive Japanese economy. Japanese companies have very low debt levels, whilst dividend growth and pay-outs are growing strongly. Valuations are compelling but the economy needs to be jolted from its two decades of anaemic growth and will only release its embedded value when global growth picks up. Japan's economic policy response remains at the global forefront of both monetary and fiscal experimentation.

Fixed interest securities FTSE British Government All-Stocks Index +4.4%

The ten year UK Gilt yield is 1.2% (the annualised return an investor receives over ten years) and the U.S. 10 year Treasury bond yield is 1.9%. We may come back to 2016 as the moment bond markets began to really question the extent to which central banks could keep their status as "the only policy game in town". Global interest rates have been driven towards zero and below but the Bank of Japan's declaration of negative interest rates at the turn of the year was widely viewed as counterproductive as other central banks reflected accordingly.

This is not to say that central banks are about to 'taper' their stimulus programmes (buying bonds and equities through the process of Quantitative Easing) but more innovative methods to boost growth are required. An increased burden towards fiscal policy is a progressive tool to stimulate economic growth but it requires a broad political consensus and will stretch budget deficits and extend government debt levels.

The divergence in policy frameworks across the major central banks remains notable. The Bank of England reduced interest rates post-the Brexit vote to support the economy whilst the U.S. Federal Reserve stands alone in raising interest rates as the U.S. economy remains resilient. However, the pace of future interest rate rises is likely to remain more gradual than first anticipated.

Credit markets (corporate bonds) rallied strongly in the 2nd quarter of 2016 but credit fundamentals have continued to deteriorate. Corporate profit margins are in decline, debt levels are rising and companies are unable to expand their sales in this slow growth environment. Liquidity, which is the ability to sell bonds in a timely manner at a reasonable market price, remains a key concern and the risk reward characteristics remain poor which is a headwind for investors with a cautious attitude to risk.

Commercial property

FTSE WMA All UK Property Index -0.2%

Industrial properties returned +1.2%, UK offices -2.5% and retail -1.4%. Demand for real estate remains high globally because the levels of income remain attractive relative to government bonds. UK returns in 2016 have been softer after a strong 2015 but supply dynamics remain tight. Opportunities look compelling in Continental Europe as interest rates are likely to remain low for years to come, European bonds offer poor alternatives for investors and occupier demand will continue to pick-up as the recovery builds. The real estate cycle is advanced in a number of other international markets and capital growth is likely to be softer going forward.

After the Brexit vote, UK real estate came under pressure as retail investors placed sell orders in anticipation of a perceived repeat of the financial crisis. However, valuations are nowhere near those 2007 highs and gearing levels are significantly lower. Retail unit trusts 'gated' their funds temporarily and applied heavy exit penalties in some cases to allow the portfolio managers to balance their books with some limited force selling. Funds have changed their 'pricing basis' which gives the impression that the underlying portfolio has been devalued but it's designed as a measure to protect long-term investors in the portfolio. This will be reversed to the upside at some stage as new money comes in. There are some concerns about the valuation levels of central London offices but markets have stabilised and demand remains strong, particularly from international investors who now receive a de-facto 20% discount following the fall in Sterling.

Alternative asset classes

Commodity prices have been in secular decline since 2010 which has informed our views for progress in emerging markets as the primary source for the world's raw materials. Prices bottomed in February 2016 in line with the US Federal Reserve's rhetoric of slower interest rate rises. Given the slow grind down over the years, the rally has been quite extraordinary with aluminium rising +54%, copper +48%, coal +49%, rice +33% and corn +22%. Gold miners have also performed strongly this year.

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Important information

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Indices performance statistics are for the period 6th April 2016 to 5th October 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.