Market commentary **October 2017**

"It would be (going) too far to suggest that there will never be another crisis, I do think we're much safer and I hope that it will not be in our lifetimes and I don't think it will be" – Janet Yellen, Chairwoman of the U.S. Federal Reserve, June 2017

Overview

In a welcome development, the U.S. Federal Reserve (the United States Central Bank) announced in September that it will begin the great unwinding of its massive $4.5 trillion stimulus programme which was first enacted almost a decade ago in response to the worst recession in living memory. This signals the first steps towards removing emergency measures that were required to keep the global economy on the tracks after the financial crisis. It is broadly accepted that the process known as Quantitative Easing (QE) has played a key role in inflating asset prices by increasing the money supply, suppressing interest rates and driving otherwise risk averse investors into more risky assets such as corporate bonds, equities, property and more esoteric assets such as fine wines and classic cars. The Federal Reserve is mindful that its new monetary policy, henceforth known as Quantitative Tightening (QT), could draw demand away from financial assets and cause substantial volatility in financial markets. To dampen the impact of this change in policy stance, Janet Yellen, the Chairwoman of the Federal Reserve was keen to reassure investors that the process will be so slow and steady that it would be akin to 'watching paint dry'.

Financial conditions remain far from normal and a decade of seemingly endless cheap finance has distorted asset prices to a degree that makes analysis complicated. For example, the German government can now borrow money for five years at negative interest rates, Tesla, the Californian electric vehicle maker, is yet to make a profit but has a market value greater than that of giant, General Motors. Amazon shares are trading at stratospheric levels and more broadly financial assets across the board are trading at all-time high valuations. The Swiss National Bank is now a significant buyer of American stocks in a measure designed to alleviate the pressure on its expensive currency, house prices in Vancouver Canada are rising exponentially and we are currently witnessing the latest investment mania with the emergence of cryptocurrencies, of which Bitcoin is the largest by value. One could have purchased a single Bitcoin for less than a $1 in 2010 and they now trade at over $7,000 a piece!

From a geo-political perspective, seismic events such as Brexit, Donald Trump and North Korea have barely registered on investors radars and markets have shrugged these events off with minimal drama. The main beneficiaries of the sheer weight of money flowing around the system has been tracker funds, particularly exchange traded funds, which invest mechanically without any reference to intrinsic value and have helped to squeeze markets higher through a positive feedback loop. Indeed, one of the main characteristics of this latest bull-market is the historically low levels of volatility that we are witnessing. The S&P 500 index, tracking the largest American companies has only fallen by 1% or more in a single day only four times this year, the fewest for a full year since 1964.

The outlook for the global economy has improved in 2017 with a synchronised upswing in economic growth from most of the major regions around the world. Global economic growth is forecast to be 3% by the end of 2017 with an encouraging pick-up in investment growth and world trade. With core inflation at 2.4%, we remain in a goldilocks environment, not too hot for inflation to take-off and not too cold to tip the global economy into recession. Europe and Asia are not in a position to raise interest rates any time soon and the UK has the spectre of Brexit hanging over it. The U.S. is much further along the economic cycle and will continue to lead the way for interest rate rises. The UK, Europe, United States, Japan, Switzerland and China are all engaged in QE policies in one form or another and the future path of the global economy and the impact on financial markets will be determined by how well they execute their withdrawal from these processes, if indeed they ever can.

UK equities FTSE All-Share Index +5.4%

The FTSE 100 Index produced returns of 4.9%, the FTSE 250 Index 6.8% and UK smaller companies 5.8% in the period under review. The value of the pound has depreciated by almost 24% against the Dollar since mid-2014 which has raised the cost of imported goods and reduced household purchasing power mainly through higher food and energy prices. Consumers are curtailing their spending habits due to the uncertain effects of Brexit and because of below inflation wage rises. The prospects of slightly higher borrowing costs has dampened demand although the demand for consumer credit has remained relatively robust. Private new car registrations declined sharply over the summer as households are becoming more cautious towards the purchase of discretionary, larger ticket items.

Greater uncertainty over the UK's colourful relationship with Europe has clearly affected the decision making of companies as business investment collapsed post-Brexit. It has stabilised in recent months but is unlikely to rebound anytime soon. However, the growth in companies demand for labour has been resilient and the unemployment rate remains low at 4.5%. Ordinarily, low unemployment should raise inflationary pressures but the growth in productivity of UK workers since the crisis has been poor. This is not necessarily a reflection of how hard we work as a society as total hours worked in 2017 have remained relatively stable and surveys have shown that part-time workers in particular would like to work more hours if given the opportunity. It does reflect relatively low levels of investment from government and business in recent years which is clipping future growth.

The Consumer Price Index (CPI) as a measure of inflation was 3.0% in September 2017, somewhat higher than the Bank of England's 2% target. It is expected that inflation will start to fall back towards the target during 2018 as these elevated levels are seen as largely transitory. Economic growth in the UK is forecast to remain between 1.6% and 1.8% towards the end of 2019 and this is consistent with marginally higher levels of inflation. It is against this backdrop and with all things remaining equal, that the base rate in the UK is forecast to rise towards 1.0% by the end of 2020.

There was a clear delineation between the best and worst performing FTSE 350 sectors. Tobacco, gas, water, utilities, fixed line telecoms, electricity, media and pharmaceuticals were all sectors found at the bottom of the performance tables as they are inherently sensitive to interest rate rises and tend to be highly indebted businesses. Conversely, industrial metals, software and computers, industrials, chemicals, mining and the electronic sectors all performed well, reacting to the pick-up in global growth.

International equities FTSE All World (ex UK) Index +9.5%

The S&P 500 Index, a broad measure of the performance of the largest 500 publicly quoted companies in the U.S. made gains of 9.0% in the period. From the second half of 2015 to the end of 2016, the largest U.S. companies experienced both declining sales and profits. Historically, this kind of financial downturn has been the harbinger of an impending recession but this time it was averted and 2017 has seen the return to strong and rising profitability. Technically, this is one of the longest economic recoveries in history although fewer numbers of people can claim to have felt the benefit. Whilst the U.S. Federal reserve has reached an historic milestone, the UK, Europe, Switzerland, Japan and China are still engaged in their QE policies which has led to an additional $1.5 trillion of financial stimulus to the global economy over the last year. This has been a very positive tailwind for financial markets and is injecting a growing belief in investor psychology that no event, financial or geo-political can derail rising markets.

Risks are building. Firstly, the European Central Bank is likely to slow down its purchase of financial assets from €60 billion a month to €40 billion and then €20 billion a month before ending their programme in December 2018. Secondly, any tapering of such eye watering sums of money which is being injected into the financial system could raise the spectre of rising interest rates.

Thirdly, the headlines are reporting soaring profits for companies to justify record high valuations but dig below the surface and it's clear to see that accounting profits, not the adjusted numbers delivered by Wall Street, are barely up 12% since 2012 whilst the market has risen about 72%. Companies have been on a huge borrowing binge over these years, fuelled by historically low interest rates, and a big part of that borrowed money wasn't used to create new things, expand, invest, or invent, but to buy back their own shares which has inflated their profits in the short-run.

In Europe, the FTSE Europe (excl. UK) index returned 8.0%. The Eurozone recovery appears to be going from strength to strength and the recovery is broadening out. The current economic growth rate across the Eurozone is circa 2.1% which is above recent trends and should have a positive effect on unemployment rate in Europe. Recent business surveys, particularly in Germany, have been at six year highs reflecting a growing confidence in the long awaited recovery. Spain and Portugal have also enjoyed strong growth while Italy remains the laggard as usual. Greece has emerged from its very latest recession but its economy in real terms is still some 27% below its 2007 peak. Inflation is subdued and it will be at least three years until unemployment stabilises at lower levels before higher levels of inflation could be contemplated. President Macron is a devout europhile and he is likely to galvanise further european integration. He will advocate greater centralisation of EU member states budgets but it remains to be seen which of the other member states wish to go that far at this stage.

The MSCI Emerging Markets Index posted gains of 15.9%. Emerging economies are projected to grow at 4.8% for this year and next, considerably higher than developed world economies. Taking a seven year view, emerging markets offer the highest projected returns when compared to other developed world asset classes. Brazil, Russia and India have experienced an extended period of falling inflation (dis-inflation) and in Latin America it remains a significant trend. Lower inflation generally signals lower interest rates and this has led to strong flows into emerging market debt, in both corporate and government bonds. Since the crisis, emerging economies have seen a steady downward trajectory in growth rates but this is showing signs of bottoming. On the international stage, agricultural commodities fell 47% in broad terms from 2012 to 2016 using various measures. Oil collapsed from $100 a barrel in August 2014 to around $30 in February 2016. For those emerging economies that imported these commodities, this was clearly a positive development for the economy, the outlook for inflation and interest rates. Brazil has already slashed its interest rate from just over 14% in 2016 to just under 8% in 2017.

In Japan, the Topix 500 returned 14.0%. The transformational economic policies of Shinzo Abe, the Prime Minister of Japan (who was re-elected in October 2017) is the driving force behind the Japanese economy. During his tenure, the Yen has weakened against the Dollar which was a key objective, unemployment has fallen from 4.3% to 2.8%, dividends paid to shareholders have increased significantly and the stock market (measured by the Topix index) is up 92% since 2012. The economy is finally growing again and is now larger in nominal terms than it was in 1997. Japanese companies are cash-rich and generating record levels of new cash. Corporate Japan has historically paid very low levels of dividends to shareholders but this is changing, which is a positive sign of increasing management discipline. Japanese companies have continued to re-invest their capital during the economic stagnation of the last 25 years and they are now trading at valuations that are very favourable to investors.

Fixed interest securities

FTSE British Government All-Stocks Index -2.3%

The ten year UK Gilt yield is 1.3% (the annualised return an investor receives over ten years, ceteris paribus) and the U.S. 10 year Treasury Bond yield is 2.3%. Using some proprietary research on forecast returns over the next seven years, UK investment grade corporate bonds are projected to return 1.7% per annum, U.S. investment grade bonds 3.5% per annum and U.S. high yield bonds 4.6% per annum.

The outlook for fixed interest markets will be determined by the future path for interest rates and inflation both in the UK and the U.S. In the UK, interest rates are at 5,000 year lows according to the Bank of England and are set at emergency levels. There is a conundrum at the heart of both the Federal Reserve and the Bank of England's analysis and it's starting to be factored into bond market pricing. Under the first scenario, the extraordinary high levels of global debt is preventing the transition to higher levels of economic growth enjoyed by previous generations and will precipitate another debt crisis larger than the last, extrapolating current trends. Deflation would inevitably reassert itself, the global economy would stagnate and government bonds should perform well and equities much less so. The alternative scenario is one under which all of this QE, with a little help from Donald Trump's tax cutting package, manufactures a reflationary environment in which economic growth picks-up significantly alongside inflation and rising interest rates. This would almost certainly herald the end of a 35 year plus period in which interest rates have declined and would create distress for fixed interest investments. Central banks would prefer an outcome somewhere in between, hence their glacial approach to ending QE in the coming years. Central banks extracting themselves from a financial system that has been grossly distorted by QE policies is not going to be easy and we are likely to see greater levels of volatility in bond markets which hitherto have represented the safe part of an investment portfolio.

Commercial property

FTSE Custom All UK Property Index 3.0%

Industrial properties returned 9.6%, UK offices 4.0% and retail 3.7%. The sector has staged a steady recovery from the short-lived jolt following the Brexit vote which placed downward pressure on valuations for six months or so. Pricing of commercial property has remained resilient as the falling value of Sterling has attracted buyers from Germany and China. Indeed, values have recovered completely in the year from the short-term shock of the Brexit vote. The industrial market is showing good rental growth running at 3-5% per annum as traditional retailers are re-engineering their supply chains to handle online orders alongside parcel delivery companies who are satisfying demand from online-only retailers. Rental yields are solid as supply of commercial property is dwindling as buildings are being converted for residential development. At an average of 5.1% rental income (after costs), this asset class remains structurally solid particularly when one compares the yields against the aforementioned fixed interest alternatives.

Alternative asset classes

Commodity prices have firmed since last February led by Copper, Aluminium, Zinc and Nickel. Since the financial crisis, commodity producers have undergone substantial reconstruction with the reduction of company debt, the selling or moth-balling of unprofitable mines and orienting business models towards new technologies with the supply of metals such as lithium, a key input for the electric vehicle market. Over the last ten years, the value differential between the commodity sector and the broader U.S. stock market has become extreme leading to discussions that put commodity investing back on the agenda.

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Indices performance statistics are for the period 6th April 2017 to 5th October 2017, total return with income reinvested.

Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.