Market commentary **April 2017**

'To start with, we have to work harder to ensure that the benefits of trade are more widely shared. And we also have to work harder to make a credible, balanced, powerful argument for trade'.
World Trade Organisation Director-General Roberto Azevêdo

'Look, there's some very good things about a strong Dollar, but usually speaking the best thing about it is that it sounds good…it's very hard to compete when you have a strong dollar and other countries are devaluing their currency'.
President Trump

Overview

The defeat of the establishment's favourite candidate Hillary Clinton to Donald Trump marks a major change in U.S. politics and potentially an even bigger change in international relations. Despite predictions of an equity market meltdown, victory helped start a reflation rally ('the Trump trade') for the United States and developed markets as his pro-business policies and promise of huge fiscal stimulus helped ignite animal spirits. In short, it would seem that investors have fully bought into Trump's promise to 'make America great again'. However, the impact of the new president's fiscal policies will not be felt until end 2017 and into 2018 and are likely to be severely scaled back. The International Monetary Fund (IMF) and the World Bank are now focussing their efforts on the backlash against globalisation with both organisations championing free trade and the free movement of labour and capital. The Brexit vote and the rise of Donald Trump are clear manifestations of the difficult task at hand. In many respects, the underlying roots of today's backlash are a lack of economic growth, falling real wages and increased insecurity, in part created by new technology.

In a break from tradition, Donald trump has started to call for a weaker dollar, reversing the convention that the president always supports a strong currency. He has consistently argued that American firms are being placed at a disadvantage by past trade deals and clearly, a strong currency is a key determinant of the ability to win business. The dollar is trading at levels (on the high side) not seen since 2002 and has strengthened by 23% since July 2014 measured against a basket of other major currencies. The U.S. dollar has been buoyed by the prospect of the U.S. Federal Reserve raising interest rates ahead of other large economies (UK, Europe and Japan). It appears that markets have traded beyond these expectations and reached a juncture where a weaker dollar is a real possibility. This could potentially be problematic for Europe and Japan but would be welcome relief for emerging markets who typically sell commodities and borrow money in dollars.

UK equities

FTSE All Share Index 6.1%

The FTSE 100 Index rose 5.9%, the FTSE 250 Index 6.3% and UK smaller companies 9.0% in the period under review. The British people will be heading back to the polling booths yet again after Prime Minister Theresa May called a general election for 8 June. The announcement took everyone by surprise as May stated that she needed an election to strengthen her hand in Brexit negotiations. Investors cheered at the prospect of a 'softer Brexit' which would be a better outcome for the UK's long-term growth prospects. The pound strengthened against the dollar (taking it to 1.28 dollars to the pound) although it is far too soon to draw conclusions as May's preferred route of leaving the 'single market' will likely amount to a 'hard Brexit'. The pound still trades some 13% below its levels before the referendum.

The election may come just in time for Theresa May as there is rising evidence that households are beginning to tighten their belts. UK inflation is rising, albeit due to temporary factors associated with higher energy prices and the depreciation of Sterling, pushing the cost of imported goods higher.

The Consumer Price Index was 2.3% in March 2017, the highest for three and half years. It is likely to peak at around 3.5% before returning to a still elevated 2-3% range over the next two years. Households in aggregate are spending every penny they earn, excluding pension contributions (which are a form of savings) with the household savings rate at close to zero. It was last at these levels in 2007-8. Retail sales are dropping sharply which is likely to feed into slower economic growth for 2017. The UK (and U.S. for that matter) have been suffering from declining productivity (economic output per hour for each worker) for over 30 years which has contributed to the feeling that workers have been displaced from secure, high-productivity jobs to low-wage, flexible employment e.g. zero-hours contracts in the UK. In many respects, political populism with commensurate protectionist economic policies are a reaction to this and could be considered as a serious threat to globalisation.

The best performing sectors of the market in the period under review were mining, industrial metals, banks and industrial engineering. These are broadly consistent with cyclical industries reliant upon the improvement in global economic growth. In contrast, telecoms companies, utilities and pharmaceutical companies which are stable but slow growth industries produced the lowest returns. Annualised economic growth is running at 1.2% in the UK.

International equities FTSE All World (ex UK) Index +10.2%

The S&P 500, a broad measure of the largest 500 publicly quoted companies in the U.S. returned 10%. The inexorable rise of Facebook, Amazon, Netflix and Google ('the FANGs') continues to dominate the performance of U.S. markets, propelled by an ever concentrated number of companies. These are all undeniably fantastic businesses but the valuations that they trade on remains elevated to say the least. Indeed, U.S. markets look overvalued on a plethora of reliable indicators that have historically predicted much lower future investment returns. Ultra-low interest rates do provide significant support to higher valuations but even this argument is wearing a bit thin.

The recent rise in equity and bond markets have been driven by President Trump's deregulation agenda and his plans for fiscal expansion through tax cuts and infrastructure spending. He is already learning about the challenges of passing legislation through Congress and will have to come to terms with reconciling his plans with those Congress members whose primary objective is to cut the budget deficit. To put this challenge into perspective, the U.S. government had a fiscal deficit of $587 billion in the year ending September 2016. The combined total gross national debt of the U.S. in January 2016 was $18.96 trillion, a staggering number. As the U.S. enters the latter part of this economic cycle, this will inevitably cause investors some consternation, mindful of higher inflation and interest rates. Markets are clearly putting a lot of faith in President Trump's ability to deliver on his promises.

In Europe, the FTSE World Europe (excl. UK) returned 12.9%. The inauguration of President Macron in France and the defeat of Geert Wilders, the far-right candidate in the Dutch elections calmed investors' nerves as either election could have produced referenda on leaving the European Union (EU). Clearly, a decision to leave the EU in mainland Europe must clear a greater hurdle than the UK given that any country would have to leave the Euro and all the chaos that such a move would entail. Headline inflation in the Eurozone rose to 2% which is above the European Central Bank's (ECB) target but like the UK, this is likely to subside with the stabilisation of energy prices. The ECB is planning to end its 'bond buying programme' from 2018 which has been the key determinant in keeping interest rates low in Europe. Indeed, the deposit rate is currently -0.4% (yes, 'a negative interest rate') and any rise in rates should be positive for European banks allowing them to expand their profit margins.

2017 started strongly for emerging economies which are growing at an annualised rate of 4.6% whilst developed economies are growing closer to 2.9%. After six years of a sustained downturn in economic growth following the Great Financial Crisis, it is a relief to finally see trade pick-up in the emerging markets. However, it is too early to suggest that this is a sustainable trend as much of the stabilisation has been due to the firming of commodity prices over the last year or so. It seems unlikely at this stage that we will revisit the collapse in commodity prices witnessed at the beginning of 2016 but we don’t appear to be returning to the very high, pre-crisis levels of trade associated with the peaking of China growth any time soon. For this to materialise, we would need an economy equivalent to China to drive globalisation from here. The only two likely candidates at this juncture are India and Africa and both are many years away (5-10 years perhaps!) from developing the infrastructure to manage such a transition. This does not preclude further emerging market performance in the meantime but gains must come from higher productivity and economic reform rather than expanding global trade particularly given the backdrop of the protectionist political agendas.

In Japan, the Topix 500 returned 10.9%. Economic growth was anaemic in 2016 but is likely to pick up towards 1.6% for 2017. Inflation is still low at 1.1% and interest rates are still negative at -0.1%. The Japanese economy continues to be supported by a huge stimulus from the Bank of Japan which is buying bonds and equities to help support the market in a bid to stimulate inflation.

The Chinese authorities are intent on cracking down on the housing ‘bubble’ and the People’s Bank of China (PBoC) have intervened by instructing a number of banks to curb their mortgage lending. Property developers invariably invest their windfalls into the financial markets which could support the China equity market. However, a significant volume of capital is leaving the country and is likely being invested into dollar denominated assets. The growth of credit in China creating a substantial debt build-up is now becoming a genuine problem. Banks are looking for wholesale or overseas funding which makes the banking system much more susceptible to a crisis at some stage in the future. The International Monetary Fund (IMF) has produced a white paper on the potential problem but the path of potential resolution is too early to draw conclusions. If China manages to avert a crisis, it will still likely suffer much slower economic growth which will reverberate through the global system.

Fixed interest securities FTSE British Government All-Stocks Index -1.3%

The ten year UK Gilt yield is 1.1% (the annualised return an investor receives over ten years, ceteris paribus) and the U.S. 10 year Treasury bond yield is 2.3%. At these yield levels, the case for holding bonds in a portfolio remains nuanced. Government bonds have been struggling since July 2016 when economists were broadly accepting that government fiscal deficits (reversing austerity) would have to be expanded to boost growth through infrastructure spending. Trump has set out his budget proposals to do just that. The dilemma at this stage of the credit cycle is that the current stock of debt, most notably in the U.S., is at all-time highs and expanding faster than the real growth of the economy. Any significant spending programme is likely to coincide with a commensurate rise in inflation and interest rates which would herald a poor outlook for bonds. However, if there was evidence of a downturn in the global economy led by the U.S., it is highly likely that the Federal Reserve would enact further Quantitative Easing (QE4) which would likely be supportive for bonds. Either scenario has its risks and is a decision very difficult to gauge.

Commercial property

FTSE Custom All UK Property Index 2.9%

Industrial properties returned +6.1%, UK offices 3.3% and retail 3.2%. 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. Investment funds that weren't forced sellers have slowly restructured their portfolios and raised cash where necessary. Surveyors have recently revised their valuations upwards as the tight liquidity conditions associated with the June vote have passed. The asset class remains compelling relative to other assets, particularly with nominal yields in the 5-7% range, substantially above both developed market bond yields and deposit interest rates. Leverage is nowhere near the levels seen in 2006-7 and supply remains tight. Rental growth is coming through and the asset class offers genuine real yields i.e. above the current level of inflation. The steady cash flows inherent in the asset class makes it a cornerstone of well-diversified investment portfolio and at the margin, the sector is likely to attract money from managers allocating away from bonds.

Alternative asset classes

Miners continued to stage a remarkable recovery from the doldrums of February 2016 helped in no small way by a huge stimulus package from China. It is likely with such a strong recovery that commodity prices such as copper will remain firmer from this point as global growth picks up in 2017 and the strength of the dollar recedes somewhat. Gold miners performed well in 2016 but have got off to a volatile start in 2017.

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Indices performance statistics are for the period 6th October 2016 to 5th April 2017, 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.