Market commentary **October 2018**

"There are ample signs of change in the wind for investors. The Federal Reserve is raising short-term interest rates and U.S. inflation is at target for the first time since 2012."

Mihir Worah, Chief Investment Officer, PIMCO, August 2018.

Overview

Perhaps it was the extraordinary summer weather in the northern hemisphere, but there is a sense that global trading activity is flagging. Whilst the world economy was firing on all cylinders in 2017, growth has been less synchronised in 2018. The US has held up well but activity in Asia and Europe has lost momentum. Markets hit an air-pocket in October with assets selling off sharply against a range of fears from the US-China trade wars to Brexit to the Italian budget proposals. In the US, most of the gains in the stock market for the year have been wiped out whilst european shares have lost about 8%, UK shares 5% and emerging markets 14%.

Global economic growth is expected to reach 3.3% in 2018 as the world economy moves firmly into the expansion phase of the economic cycle. Given the economic recovery is now ten years on from the Great Financial Crisis (the GFC), evidence suggests that we are now embarking on the late-cycle investment stage. This is predicated upon rising core inflation, low unemployment, strong profit growth, record corporate profit margins, rising house prices, strong manufacturing numbers and rising short-term interest rates. There is a real risk of an uptick in inflation and under this scenario, we would expect commodities to perform well alongside inflation-linked bonds and real assets such as bricks and mortar property.

The US economy is showing no signs of wobbling and is running hot at a projected growth rate of 2.8% for 2018, significantly stronger than the Eurozone at 2.0% with the UK slowing to 1.2% and Japan down to 1.0%. Unemployment in the U.S. is 3.7%, the lowest in almost 50 years and consumer confidence remains at record highs. Whilst growth has been healthy, it has prompted interest rate rises in the US with the 10-year Treasury yield rising to 3.2% from a historical low of 1.3% in 2016. The Treasury yield is effectively the interest rate at which the U.S. government borrows money over ten years. This rate was a staggering 15.7% back in September 1981 and fell consistently for the next 35 years as interest rates across the western world fell but the breach above 3% for the first time since 2014 raises borrowing costs significantly given much higher government debt levels. Short-term interest rates are 2.25% in the U.S. and market expectations are for three further rate rises to 3% before the Federal Reserve will pause for breath in mid-2019.

Quantitative Easing (QE) policies are being scaled back significantly by the US, Europe (at the beginning of 2019) and Japan (a gentle scaling back over time) and will remove some of the largest purchasers of financial assets in the markets. After supporting the global economic recovery over the last decade, their withdrawal will be a serious headwind to financial asset prices in the coming years. Against this backdrop, the challenge for the Federal Reserve in 2019 will be to raise interest rates to cool the US economy without choking-off the robust recovery, a risk known as "Fed overkill' (raising interest rates too fast). This is easier said than done but it will be the focus of attention for strategists, economists and portfolio managers in the coming year.

Emerging economies are forecast to grow by 4.9% per annum in 2018 whilst China's GDP growth is to continue its secular decline (although it's still growing at 6.5% per annum) exacerbated by trade wars. A strong US economy and rising interest rates has supported a strong Dollar against a basket of global currencies, which has been negative for emerging markets as they borrow money and trade commodities in Dollars. Currency markets tend to move ahead of the interest rate cycle and so will likely anticipate the peak in US interest rates in 2019. This should provide some welcome relief to emerging markets.

UK equities

FTSE All-Share Index (excl. Inv Co's) 4.0%

The FTSE 100 Index returned 4.2%, the FTSE 250 Index 3.7% and FTSE Small Companies 3.5% in the period under review. Economic data remains broadly positive in the UK given the uncertainty of the Brexit negotiations although CBI surveys are pointing to a weaker spell in the economy as the uncertainty is delaying business investment. An anonymous protestor in London, 2018 aptly defined the current position as "the undefined being negotiated by the unprepared in order to get the unspecified for the uninformed". It is difficult at this juncture to make any reliable forecasts, although the outlook for the UK could improve further if there is news of a deal on Brexit. Wage growth (excluding bonuses) is growing at annual pace of 3.1%, which is the highest reading since the financial crisis as unemployment has fallen below 4%, the lowest level since 1975.

There has been a seismic shift in the political landscape in recent years particularly in Europe and the US with the rise of populism and this is seen as a genuine challenge for politicians over the next decade. Populism is generally ill-defined but, in this note, it is a recognition that there is a proliferation of low-skilled and hence low paid jobs creating a disenfranchised section of society, that are demanding a change in the way the economy works for them. Whilst the 1980's and 1990's saw a wave of privatisation and de-regulation of industries, the trend is likely to be reversed in the next decade with political parties reviewing the chance of taking banks, utilities, transport and defence companies back into the government sector. The bankruptcy of Carillion last year was an early warning sign of how difficult it is for private companies to make profits from government contracts and in this calendar year, utilities have taken a noticeable dip in share price terms, even as the underlying cash flows have remained relatively robust. The sector is now offering high dividend yields but, in some cases, high enough that the regulators may force some top-slicing.

Bank shares can be purchased at historically low valuations but have continued to pay-out a seemingly endless stream of compensation payments for their bad behaviour in the financial crisis and remain hamstrung by low interest rates in the UK and Europe, crimping profitability. They have tried to improve profitability by issuing mortgages at standard variable rates (SVR) at significantly higher levels than the Bank of England base-rate, but it seems inevitable that regulators will turn their attentions to this practice at some stage. The calls to nationalise the British Rail system seem to grow stronger with poorly performing lines and poor customer satisfaction. Each one of these sectors offers easy vote winning opportunities and for that reason, they offer political risk to investors and intangible risk to build into investment analysis.

There are plenty of investment themes which are demonstrating resilient investment characteristics that can be garnered from UK listed companies. Modern shopping centre developments, oil and gas exploration and refining, mining, mobile phone networks, companies with exposure to fast growing emerging markets, cloud-based I.T. solutions, parcel distribution centres to handle the growing online market, border security and medical advancements alongside the day-to-day requirement for vaccines to name a few. Other areas like the residential building sector appear to offer some value but we'll need some clarity on Brexit to see some of that value realised. We are looking for corporate resilience at this stage of the investment cycle.

International equities

MSCI All Companies World (ex UK) Index 6.4%

The S&P 500 Index, a broad measure of the performance of the largest 500 publicly quoted companies in the US returned 11.9% in the period. Financial markets have been focussed on the trade wars with China following the US decision to impose tariffs on another $200 billion of imports from China. China has responded by putting tariffs on $110 billion of US goods, which covers about 90% of all China's imports from the US. Calculations suggest that China will be hit hardest unless progress is made in the trade talks. As Donald Trump said, 'trade wars are good and easy to win' and the markets appear to be backing him as the China A-Share Index has dramatically underperformed the US stock market. President Trump came to power promising 'to put America first' and he draws from his base support believing that the China trade deficit (China exports more goods to the US than vice-versa) is the root cause of declines in certain parts of the US economy. The Trump administration is ultimately hoping that production will be brought back home. Manufacturing will be much costlier in the US than in China and is inflationary.

In Europe, the MSCI Europe (excl. UK) index returned 2.0%. The Eurozone economy has been slowing markedly in 2018 but will still likely grow by 2% by the end of the year which is satisfactory. The European Central Bank (the ECB) is going to end its QE policy in December 2018 before considering raising interest rates in 2019. European investors have been fixated on the political budgetary showdown between the Italian government and the European Commission since the summer. Italy's huge public debt mountain (132% debt to GDP, the UK is 88% for context) has been a concern for investors for some time, but the threat of a splurge in government spending by the new populist coalition government has caused investors to push Italian bond yields up (increasing the cost of borrowing over ten years for the government from 1.7% in May to near 3.5% today). In the long-term, Italy will struggle to keep borrowing under control and this political pantomime is likely to repeat next year. Italy is highly vulnerable to a loss of confidence from investors as unlike Greece, Italy is simply too big to bail-out. Despite its fragilities, past governments have been able to keep a tight rein on Italy's finances. It is not the European Commission that Italy needs to fear, its government bond investors who will withdraw their support if the situation becomes too fiscally unstable.

Manufacturing appears to be the weakest link in the Eurozone, especially export orders. This is backed-up by earlier statements about falling global demand, which has been evident since mid-2017. The German car manufacturing sector is showing striking weakness, corroborated by a 30.5% fall in new car registrations after the introduction of tougher emissions standards. Lower exports to the UK can be explained by the weaker pound and lower exports from Asia are probably due to the short-term impact of the US-China trade war overspill to various supply chains. In the bigger picture, the Eurozone is still relatively healthy with above average wage growth, falling unemployment and signs that governments will raise their spending in 2019. Mario Draghi, President of the ECB stated that "we're talking about a weaker momentum, not a downturn" but acknowledged some of the risks are starting to build.

Emerging markets have had a tough run in 2018 with rising US interest rates, fears of tariffs, trade conflicts and political uncertainty in Mexico, Brazil, Turkey and Argentina. Emerging economies are still forecast to grow by 4.9% in 2018 before slowing to 4.6% in 2019. China will likely continue its secular decline exacerbated by the US trade wars. When interest rates rise in the US, financial capital flows out of emerging markets seeking higher returns. Emerging market currencies are weakened, and this puts pressure on the political institutions and/or creating financial crisis in the case of Turkey and Argentina.

In Brazil, Jair Bolsonaro was elected President as financial markets were rooting for the defeat of the left-wing candidate with the hope of a move to more free-market economics. Brazil's debt to GDP is remarkably high for an emerging economy at 84% and the government continues to overspend. Much of the budget is spent on social security and the country is in dire need of pension reform as 80% of pensions currently go to the public sector. Mr Bolsonaro's rhetoric is generally unpleasant and controversial, in a mirror of his US counterpart, but he will need to embrace a more economic liberal agenda. Rather like the other Latin American economies, the currency has room to appreciate (improving investment returns) and stock markets should perform better given the better outlook for economic growth.

In Japan, the TOPIX 500 returned 5.3%. The Japanese economy has grown sluggishly by 1.0% in 2018. Unemployment in Japan is at a 25-year low at a staggering 2.5% and 1.6 people on average are chasing each vacancy, a ten-year high. There are severe labour shortages which is putting upward pressure on wages. Alongside the US and Europe, Japan is withdrawing from its post-financial crisis QE policies. Female participation in the labour force is still relatively low at 52% and female workers are taking up more part-time roles, which will take up some of the demand and keep a lid on inflation. There are other potential sources of labour such as foreign workers, although Japan still operates very strict immigration policies. The Japanese government is embracing the idea of using robotics as part of the solution as the '2025 crisis' (the baby boomer generation turns 75 years old) looms. The robot revolution is the next industrial revolution and includes the development of other investment themes such as 'the Internet of Things', big data, Artificial Intelligence, robotics and the sharing economy.

Fixed interest securities

FTSE British Government All-Stocks Index -2.1%

The ten-year UK Gilt yield is 1.5% which is the estimated annualised return an investor should expect to receive over ten years and remains below the rate of inflation. The equivalent US 10-year Treasury bond yield is 3.2%. In a broadly rising interest rate environment, fixed nominal bonds will underperform as investors prefer to wait for the prospect of higher interest rates, although they remain uncertain as to when the interest rate cycle will peak. In this regard, most of the major bond markets have lost money this year, providing a difficult dilemma for portfolio managers who use bonds to reduce risk in their portfolios. The US Federal Reserve is raising interest rates faster than elsewhere and markets are expecting at least three further interest rate rises into the first half of 2019. Interest rate policy will be determined mid-2019 by the strength of US economic data, mainly inflation, the jobs market and the strength of the US economy. Steeper interest rate rises would be a problem for stock markets and bonds alike.

Commercial property

MSCI IMI Liquid Real Estate -2.0%

IPD UK All Property returned 3.9%. Within that figure offices returned 3.5%, retail 0.6% and industrials 8.9%. Investor preference remains favourable towards the property sector particularly given the alternative low yields from Gilts Sentiment towards retail space and central London offices generally remains negative but there is strong demand for industrial assets. 2018 has been dominated in the headlines by Company Voluntary Agreements (CVAs) announced from major brands like House of Fraser, New Look, Carpetright and Poundworld. Not all will close but property values in prime and secondary shopping centres have fallen. Department stores are performing poorly whilst supermarkets are the best performing area of the retail property market. It is notable that the proportion of speculative office space under construction is not far from the peak in 2007. The industrial market continues to perform well with e-commerce a key driver of values and rental growth. Development is dominated by distribution warehouses. The leasing of office space across the country remains robust and very strong in London. Occupiers are looking for more than desk space in their working environments presenting development opportunities to landlords. There is demand for multi-let, co-working environments with a community of workers sharing amenities and more extensive support services.

Alternative asset classes

Crude oil is trading at $60 a barrel, off from its recent highs of $76 a barrel. The S&P 500 Index has outperformed a broadly spread commodity index substantially since the 2008 crisis. Indeed, the disparity is at record levels only seen in the late 1990's and the early 1970's. We would expect commodities to close the gap and we see continuing evidence of mining companies, restructuring their operations and paying stable dividends.

Paul Farrant, Chartered Financial Analyst

If you would like to find out more or speak to one of our advisers, please contact us: t. 01727 837128 e. info@ifpc.co.uk

Indices performance statistics are for the period 6th April 2018 to 5th October 2018, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.
Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.