



GLOBAL MARKETS BULLETIN

Quarter 2: 2017

General Economic Overview

Global growth has been moving positively through the second quarter of 2017, although it is below trend. The continued economic growth of around 2% has surprised some economists given the level of underlying uncertainty created by political changes and differing central bank agendas. The US has continued to show growth, but may well be challenged as employment rates have reached all-time highs and little policy progress is being made between Trump and Congress. Europe has been a strong growth area with peripheral countries such as Spain and Ireland delivering better numbers. The Japanese economy has also surprised on the upside thanks in part to a weaker but stable currency. Asia and emerging markets have also benefitted from the general stability of the dollar in 2017 and its more recent weakness, but concerns remain that this positive momentum has continued beyond a normal business cycle, despite some more positive news on company earnings through 2017. Stock markets have been robust through most of the year, treating political upheaval as minor speed bumps along the way to higher market levels.

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The fears of political shifts and the rise of populist parties in Europe have been on the agenda since the UK vote to leave the EU in 2016, but this has failed to materialise – other than in the UK where the uncertainty was perpetuated following the recent general election. The Dutch and French elections both saw centre candidates overcome any extremes and, although there are more elections this year, the momentum of the populist agenda has been largely subdued. This has meant that European markets have concentrated on the positive economic news in the second quarter which has helped to drive market values higher with Europe being the strongest performer over the last quarter. We still have Donald Trump in the White House creating uncertainty but his initial policy drive has not found favour with Congress and many of the manifesto pledges may prove difficult to execute.

Concerns have been raised about volatility, or the lack of it, in the last few months as markets have been more resilient to political change, with greater security created by the reducing fear of Eurozone instability, helped by the recapitalisation of Italian banks. The snag is that the absence of volatility may be as much to do with monetary policy being accommodative as with global growth or the robustness of financial systems. The danger therefore is one of complacency, where lenders and consumers assume greater stability and relax their controls in both of these areas creating higher levels of debt. Should economies be seen to be more robust then investors may have to confront a new reality of higher interest rates and reducing central bank balance sheets, with corresponding effects on a higher debt-laden consumer.

Overall the global economic position looks more stable at the end of quarter two but we are eight years into a positive market cycle supported by accommodative monetary policy, with many investors questioning how long this can be maintained if such policies begin to be unwound.

Equity Markets Overview

Markets generally continued with the momentum from the first quarter with all the main indices posting positive returns in sterling terms, with the exception of the US. In local currency terms the returns were better given the improved strength of sterling.

Most of the returns were achieved in May, with April and June broadly negative overall. Globally the markets seem to have put aside the political worries that were holding back investors at the beginning of the year, and for many the only real blip has been the UK elections which saw a weakened Conservative party returned to power. Most global markets benefitted from the stability of the dollar, particularly the Asian and emerging markets where currency fluctuation tends to be detrimental to consistent market growth. Europe was also a beneficiary of stability and of the improvement in sentiment following the elections in the Netherlands and France. One theme to watch for the rest of 2017 is the shift to favour stocks less exposed to the business cycle; the market has seen value stocks underperform in the first half of 2017 and the difficulty now for investors is to continue to justify buying into the growth stock momentum.

UK

With just over a year having passed since the EU referendum, to the surprise of some, the UK economy has continued to grow, although the rate of expansion has slowed of late. The three quarters after the vote have shown an annualised rate of GDP growth of 1.8%, whilst unemployment has fallen from 4.9% to 4.6%. The headline numbers are less encouraging than they first seem as household consumption accounted for more than four-fifths of the economy's expansion. Perhaps this is not as surprising as it first seems, as the majority of those who voted were in favour of Brexit and therefore got what they wanted, something unlikely to dent consumer confidence in the short term. Business investment made no contribution, whilst net exports detracted.

The most recent data shows prices rising at an annual rate of around 2.9%, but regular wages increasing only by 1.7% and so, a year after the referendum, most households will be worse off. The UK savings rate has already fallen to its lowest level in over 50 years and strong consumption is unlikely to be sustained if it is accompanied by falling incomes. Brexit is also forming a barrier for some firms in terms of capital investment into the UK with a number of financial institutions initiating expansion into European hubs to cover any hard or negative trade deals that may come out of separation from the EU.

Other data is still supportive of continued growth of the economy with unemployment less than 5% and UK PMI data still positive after the election blip. Consumer spending is however causing some concern as data from companies such as Next suggest it is starting to fall, and Nationwide house price data is also indicating declines in 2017. A number of managers are positioned with an underweight to the UK at the moment.

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US

As the US nears full employment, wage growth and inflation would be expected to increase leading to a rise in interest rates. To date, wage growth in the US has remained muted and different geographic regions and industries are seeing hugely varying trends and conditions, with some companies and sectors, ranging from manufacturing and construction to healthcare and agriculture, warning of a lack of qualified employees. At a time when the unemployment rate is the lowest since the beginning of the century, economies would be expecting a period of accelerating wage and price growth. Other parts of the States are not as buoyant and last year's election was dominated by concerns over poor job prospects in traditional Democrat heartlands which resulted in the election of Donald Trump.

For the Fed, core inflation has remained resolutely below target and hopes for a speedy Republican fiscal stimulus have receded. The latest jobs figures released in early June for the month of May showed hiring undershooting expectations, and growth in average hourly earnings is still no stronger than it was three years ago at around 2.4%. Core inflation has fallen back to just 1.5% in April. A subdued inflation picture has resulted in diverse views in the media from different Fed members with James Bullard, the St. Louis Fed President, questioning the Phillips curve that links unemployment to price growth as he does not believe inflation is heating up.

One factor behind this more complex recovery has been the uneven upswing in the US jobs market. The traditional industrial heartland of the mid-west has seen much slower median wage growth from 2000 to 2016 than the North East of the country. Many rural and poor urban regions have entrenched unemployment and college graduates have fared much better than lesser educated members of their peer group. In contrast, across large parts of the Northeastern Seaboard job conditions are tight and overall unemployment is now around 4.3% - below what the Fed believe will be the long-term rate of 4.7%.

Valuation continues to be a concern for many investors as the US markets reach new highs. Although the earnings season has been generally positive, certain metrics still suggest that markets are frothy. With PEs at 27-30x and price to book ratios over 3, data indicates it makes sense to look to other areas of the globe where value is more obvious.

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Europe

The European economy has seen significant improvement in data over the last 12 months and 2017 has shown that it is now expanding, particularly in many of the peripheral economies that struggled most after the financial crisis, such as Spain. There are still many hurdles to overcome, not least the effect of the Euro which has strengthened in 2017. The Brexit headwinds remain, as does some political uncertainty, but most of the recent elections have seen centrist political parties overcome the populist parties that were threatening the traditional equilibrium. The Italian banks were causing concern but some of this has abated as the Italian government has agreed to pump €5bn into two of the failing banks with €12bn of additional guarantees. In Spain, Banco Popular was also rescued by Santander.

More recently investor sentiment has turned more positive with data from the recent earnings season much stronger, and relative valuations in Europe are better than other areas of the globe, which is another factor fuelling investment in the region's companies. A number of managers have an overweight to Europe because of this growth improvement and the relative valuation of companies compared to other markets such as the US.

Asia

The election of Donald Trump as US President initially had a negative effect on Asian markets, but his inability to deliver policy objectives together with a weak US dollar have helped ease monetary conditions within Asia, and have helped boost stock markets which are now receiving earnings upgrades.

The rate of economic growth in China, while slower than in the early years of this decade, remains in line with government targets, helping both the Asian region and the global economy. There remain longer-term concerns about the level of debt, particularly corporate and other non-government debt that has been built up, but China is unlikely to see a systemic banking crisis due to its closed financial system. Domestic consumption continues to be strong, supported by continued wage growth. The Chinese currency, the Renminbi, has also stabilised as authorities have stemmed capital outflows.

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India should continue to benefit from its young labour force, a factor also true of the Philippines. Inflation levels have generally fallen throughout the region due to lower commodity and oil prices and this should benefit many countries in the region that are net oil, energy, commodities importers. We expect the strong domestic consumption story in Asia to continue for many years to come and believe this remains a region with excellent long term potential for investors.

The Asean region did suffer a sharp setback following the election of Trump, but this year's softening of the US currency should be a benefit at the individual country level. In Indonesia, after a period of subdued growth (Q1 GDP growth was 'only' 4.8%), the economy is also improving, helped by the lagged impact from 2016's commodity price rises. Tax revenues have increased 15% (helped by the world's most successful tax amnesty), lower interest rates (50bp over the last twelve months, when the US Fed has been raising rates), and the government's focus on significantly increased infrastructure spending. Other areas of interest include Vietnam where the economy continues to demonstrate impressive growth, accelerated in Q2 to a 6.2% year-on-year GDP growth rate, from 5.1% in Q1, despite a weak mining sector knocking 1pp off growth.

Japan

The Japanese economy expanded for four consecutive quarters in 2016, and growth has continued in 2017 with GDP expectations exceeded. The majority of the growth has come from exports, although there are signs domestic consumption is benefitting from a tight labour market. The Bank of Japan believes a tighter labour market will eventually allow the country to hit its inflation target, and in the meantime monetary policy will remain accommodative. Whilst the level of government debt remains high with interest rates at very low levels, Japan should be able to service this debt for some time without any major issues. The Topix has risen around 6% this year and has generally been rising since 2013 mostly based on and correlated to the dollar / yen rate but decoupling has now set in, with the yen Topix correlation falling to 63% from 86% in March 2016.

Valuations remain attractive relative to their history, on both Price to Book basis and versus other markets and Japan is benefitting from an increased focus on shareholder returns and better corporate governance. Dividend pay-out ratios have scope to rise from low levels by international standards. Other market movements may depend on foreign investor sentiment and whether there are more signs that the government and the Bank of Japan's policies can lead Japan into a period of sustained economic growth. A weaker yen would be of major benefit to the stock market were it to occur.

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Emerging Markets

Country effects are often an important factor within emerging markets, and this has been seen to recently in Brazil as new President Temer has been caught up in the corruption scandal. In contrast Mexico has rebounded as President Trump's bark has proved worse than his bite. India continues to benefit from the Modi reform program.

Many commodity prices have softened in 2017 and within the region, there are losers and winners but it is generally positive for Asia, especially the fall in the price of oil. The opportunities in emerging markets are becoming increasingly theme-, country- or stock-specific with wide dispersions within the investment universe. The growth of e-commerce at a pace even faster than the West has thrown up some exciting investment opportunities in contrast to the regions more cyclical names.

Valuations versus develop markets remain attractive at headline levels and in the absence of a sharp rise in the US currency, the GEM universe continues to offer excellent long term potential to skilled active managers.

Fixed Interest

The fixed interest element of any portfolio has probably been the most difficult to manage over the last five years, with the continued fall in yields being supported by accommodative monetary policy. The result of this has been that those investors with longer duration portfolios have benefitted significantly in terms of capital appreciation. For most investors the last two years have been most difficult as interest rates in most western economies have been at record lows with negative real rates after inflation is taken into account. With such low rates the consensus view has been that they will move up as monetary policy normalises and central banks reduce bond buying. The US has already begun this path of tightening but are at the moment the only major central bank doing so. For the retail investor such low rates leave little potential for capital appreciation as lower rates seem unlikely, and a conundrum about how to invest the defensive elements of their portfolios if rates move upwards.

There has been no easy solution to this dilemma, but the broader consensus now suggests a coming together of central bank policy with the gradual reduction in bond buying programmes outside of the US and the shrinking of balance sheets by the Fed, which may well then lead to higher natural rates before any interest rate rises. The likely raising of rates in the UK, Europe and Japan still seems some way off given the level of economic growth and the current inflation levels. For many investors this has meant holding shorter duration assets and this has been reflected in a number of strategic bond fund managers. At the end of the quarter we saw a jump in ten year government bond yields in the US and the UK perhaps signalling a shift in the cycle. Traditional thinking would suggest ten year yields should be around nominal GDP levels, and so there could be

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further price weakness in government bonds over the next 12 months. The next question is how far yields are likely to rise given the current nature of economic growth and the point we are in the economic cycle. Growth is not expected to be much higher in this cycle so we may well see a lower level of long term rates become the norm, leaving bond investors less exposed than once thought several years ago.

There have been areas of good positive return, including emerging market debt and areas of high yield, where spreads have gradually come in helped by the lack of defaults. High yield debt has always shown a stronger correlation to equities than government bonds and therefore the improved growth outlook is a positive for this asset class. Equally a number of bond fund managers have developed highly diversified portfolios to contend with this type of environment, using instruments such as asset backed securities and floating rate notes.

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Property

The commercial property market has little to report at the moment with the emphasis on quality ahead of secondary property, and the development of distribution warehousing or the 'Amazon effect' is probably the only area of definite expansion. With the property market relatively inert, the likely returns for investors will be focused on income rather than capital growth. The impact of the UK's vote to leave the EU on the direct UK commercial property market continues to lessen following the initial negative reaction.

As an asset class, the fundamentals for commercial property have not changed with the potential for a continuation of an impact on valuation of those properties, sectors and regions that have experienced the greatest price rises in recent years. This would be applicable to Central London as well. The weakness of Sterling versus overseas currencies has countered this (to some extent) as property becomes more attractive to overseas buyers. Returns are still expected, for the remainder of 2017, to remain reasonable but with absolute returns more muted than recent years. The driver of returns will primarily be income with capital growth limited (in some cases negative) with rental growth becoming a more dominant factor for performance. In a low interest rate environment, the asset class continues to be a solid option for income seeking investors as well as for diversification purposes in portfolios but the liquidity issues experienced in 2016 still provides cause for concern. The secondary market versus primary property yield gap remains attractive but the selection of the individual property will continue to be important.

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Summary

The global economy has established a relatively stable level of growth albeit below the level needed for outright expansion and this has been reflected in the continued momentum in equity markets. Economies in Europe appear to have turned the corner switching from recession and into growth and emerging markets and Asia have shown strong growth in 2017. This level of stability should encourage investors to look for areas of value but instead there remains an underlying level of caution as many hold relatively high levels of cash and continue to pursue the perceived safer growth stocks rather than those more dependent on the business cycle. There was a brief value rally at the end of 2016 but this has long petered out.

The caution may reflect left over political uncertainty in Europe and perhaps the US with Donald Trump seemingly struggling to get policies approved in Congress. We also face the fact that markets and multiples appear to be very high at the moment with certain markets such as the US, and within that certain sectors such as technology reaching all-time highs after an extended bull run lasting over eight years. When any set of data starts to pass existing milestones investors question the longevity of the trend and this period is no exception. Another factor being taken into account by investors is the changing stance of global monetary policy. Since the financial crisis this has been highly accommodative across the globe but as central banks start to wind down their asset buying and look to raise interest rates, asset prices should start to be driven more by fundamentals. The typical risk on / risk off pattern that has driven markets for most of the decade has started to break down with correlations now falling after an extended period of increase. This broader dispersion of returns from asset classes will bring challenges and opportunities as normalisation of interest rates and central bank balance sheets takes place. There is no guarantee of this of course, as we may well see further, as yet unknown, events overriding this trend but current policy indicates that investors need to be prepared for this process of normalisation.

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In this type of environment it is very difficult to pick out clear areas of value although we can probably point to favouring equities over bonds, and within that European and Asian markets ahead of the US and the UK. There remains no substitute for continuing to hold a broad based portfolio with exposure to traditional areas of investment as well as consideration of alternatives to broaden this diversification.

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April 2017

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