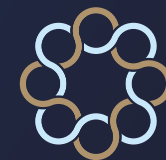

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MARKET REPORT Q3 2017

MARKET COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

What will stop stock markets making new highs? Even the threat of nuclear conflict with North Korea and terrible hurricanes has not dented the steady rise of markets over the past quarter.

The FTSE All World Index has risen 1.9% over the last 3 months (see figure 1). Let's examine what is going so well around the world, despite some scary headlines.

The US stock market is the largest in the world, and the US economy appears to be doing just fine at the moment. Growth of 3.1% in the second quarter of 2017 is strong, boosted by robust consumer spending, itself a reflection of a strong employment market. This rate will not be matched in the third quarter after Hurricanes Harvey and Irma, however the rebuilding to follow will lift growth later on. If Trump succeeds in cutting corporate tax rate from 35% to 20% companies may increase employment and push on with capex, giving another fillip to the economy. How these tax cuts will be paid for is a moot point for the time being.

Europe, although not expanding at the same rate as the US (annualised growth of 2.6% in Q2, 2017) is showing mixed signs of a recovery. The Netherlands witnessed a growth rate of 6.2% while Italy only managed 1.2%. The European Central Bank's (ECB) monetary stimulus may at last be having some positive effects. Sentiment has also been helped by election wins for Macron in France and Merkel in Germany, albeit the populist vote in both countries did increase. Severe problems remain in Europe, unemployment is over 9% while completing a banking union and moving closer towards fiscal union remain sensitive topics.

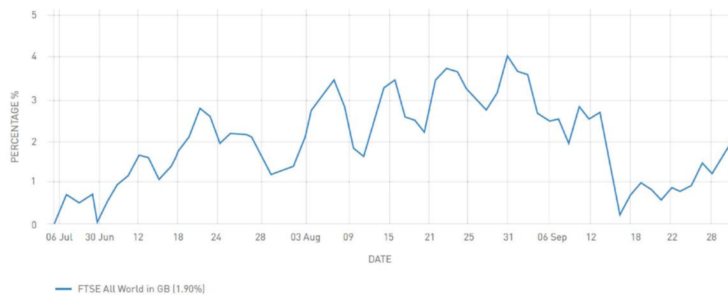
Emerging Markets continue their sparkling rise, up 4.3% in sterling terms in the last three months, the top asset class performance. The bounce back in commodity prices has helped and so has a weaker US dollar. Stronger domestic currencies for Emerging Markets nations reduces their inflation. China remains important for the asset class with growth of 6.7% forecast for 2017. Investor interest in the long term case for Emerging Markets has risen, after some disappointing years. Brazil for example is up 25% in 2017. The better growth potential in Emerging Markets combined with cheaper valuations make for a compelling investment case.

Finally, the UK, where the Brexit talks appear an all-consuming passion for the media. Whether the UK agrees a trade deal with the EU within the agreed timetable looks less likely with each successive round of negotiation. The German equivalent of the CBI has told its members to expect a hard Brexit.

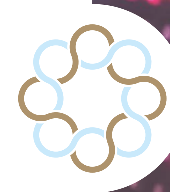
Surprisingly the Bank of England did increase interest rates in November. Given that wage growth is not picking up and that inflation is likely to fall once the effects of 2016 sterling depreciation drops out, any move up does appear puzzling. Although the rise will be welcomed by savers, too much pressure on the consumer, the mainstay of the economy, would be unfortunate.

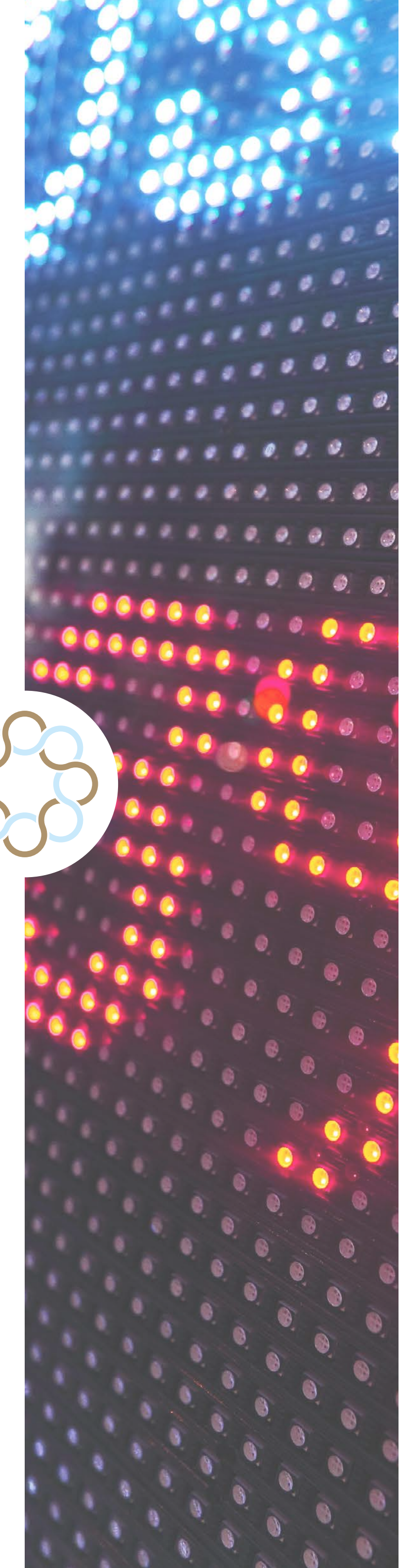
So apart from our local concerns in the UK, in particular with our politics, the world continues to grow and get richer, and that should be good for both stock markets and investors.

Figure 1. FTSE All World Index



First published by Simon Brett, Director & Chief Investment Officer at Parmenion Investment Management.





SYNCHRONISED GROWTH: ANOTHER SURPRISE

"History is merely a list of surprises. It can only prepare us to be surprised - yet again." Kurt Vonnegut.

Markets enter the last quarter of 2017 at levels inconsistent with the fragile nerves of UK investors, sitting on substantial profits. The S&P 500 Index ended September over 2,500, some 300 points or 14% above its level of a year ago. Ignoring the likelihood of a further interest rate rise in the USA before Christmas, US shares keep edging up on the back of good economic statistics and corporate earnings.

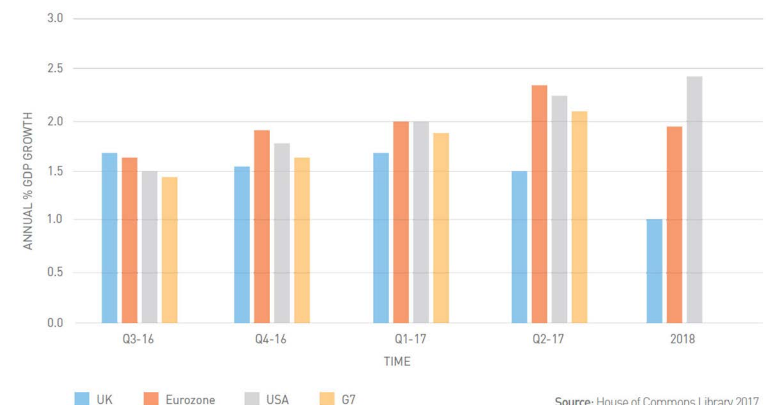
There are two reasons for our anxiety, one relative to our situation in the UK and the other, a subtle question of balance, making sense of the current strength in world markets, but which may give a frame of reference for change in due course.

The mood at home is not cheerful. Right now the UK is experiencing a genuine existential crisis, in its search for the best way to leave the EU. We literally do not know what the future will hold. Will anyone in the 'rest of the world' make it a priority to play ball with the UK? This doubt is infecting UK politics. The Prime Minister failed in her attempt to improve her majority and increase her personal political capital by calling a General Election, and is a weakened figure, having to fend off predators. Like David Cameron in his 'hug a hoodie' phase, her policy annoucements have awkwardly become more socially concerned, reflecting Jeremy Corbyn's relative success in capturing the younger vote. The anxiety has fed through to UK markets where traders have been betting against the domestic market, in the Brexit trade, interestingly without much success.

But our pattern of economic growth is not as strong as 'everyone else'. The most recent data from the ONS shows that growth in the UK, which was at the top of the list in 2016, is now lower than all other members of the G7, meaning USA, Canada, Japan, Germany, France and Italy. Needless to say, at 1.5% annualised growth in the second quarter, our economic progress is far below that of China, not a member of the G7 club, which grew at 6.9% annualised in the same period.

This points to an objective factor underpinning markets. World growth at the moment appears to be expanding in a reasonably synchronised fashion, in North America, Europe and Asia. Worries about a US recession which were the talking point in 2016 have receded, while Europe has gone on a tear, and expansion in the Far East continues.

Figure 2. Annual % GDP Growth
(with 2018 OECD forecasts)



Australia has just set a record for over 100 quarters without a recession. Meanwhile, there is little evidence of inflation on either a global or national basis. This is crucial for central bankers whose role is to defend economies against its ill-effects; think back to the periods in which it ran out of control, the 1920s, 1970s and late 1980s. Without inflation their justifications for increasing rates look slim.

So, with growth continuing in this 'synchronised' pattern (except in the UK) and without threats from inflation, the low interest rate environment looks set to continue. In that context markets can continue to hold up and reach new highs. But this equilibrium may be as fragile as the nerves of the Prime Minister. A shock to growth figures, a change of sentiment towards the US tech sector, a policy error by central bankers, or a kick up in inflation, any of these factors could change the analysis. It is probably fruitless to speculate. All we know is that we can expect to be surprised by the next big development. It might just be something positive for the UK.

First published by Patrick Ingram, Retirement and Investment Specialist at Parmenion Investment Management.

CENTRAL BANKS STILL SPOOKED BY THE GHOSTS OF THE PAST

The recent increase in interest rates announced by the Bank of England leaves us with no more clarity about the direction of monetary policy than we had before the micro-adjustment. Indeed, the increase raises rather more questions than it resolves.

Ostensibly, the 0.25% move simply reverses the rather ill-judged post referendum cut. However, we have no clear understanding of whether we are at the start of a sequence that will see regular increases in rates along a path towards normalisation or, alternatively, whether this move was simply a nod to those worried about inflation becoming more embedded. If the former, how will the sequence emerge; if the latter, to what extent will the Monetary Policy Committee's (MPC) nerve be tested by future trends in consumer prices?

The real question relates to the collective mood of the MPC. In the United States, it would seem that there has been a swing in sentiment about the Federal Reserve. Following the first rate rise there – in November 2016 – the Fed published projections showing that the intent was to edge up rates very gradually over the forthcoming few years. Nonetheless, it was still rather more focused on the risks rather than the rewards of normalisation. As a result, it continued to look for excuses to temper the pace of the tightening. Earlier this year there was a distinct mood change, and it would seem the Fed is now looking for reasons why it should not continue along the rate path it has projected. That is not to say that attitudes could not change again. However, it would appear that the Fed has become more confident in taking rates towards more normal levels it will not bring the economy to a juddering halt.

It seems unlikely that the MPC has yet reached its moment of Nirvana – or that it will reach it anytime soon. With some justification, it can claim that the position of the UK has been made more complex by the decision to leave the EU and the consequent increase in economic uncertainty. So, although the Bank's inflation forecasts imply that rates will have to rise if the inflation target is to be met by the end of the forecast period, the MPC is unlikely to feel under undue pressure to ensure this through pre-emptive rate increases. In other words, when assessing the balance of policy, the MPC is still likely to regard the possible economic risks of higher rates as outweighing the potential rewards.

In public, we often see and hear the guardians of monetary policy congratulating themselves for taking the aggressive actions that helped the economy avoid the implosion that could have resulted from the financial crisis. In its more private moments, however, the committee must reflect on the fact that it presided over the policy environment that not just tolerated, but actively encouraged, the ruinous build up of debt that in large part caused the crisis. Economic historians will not be as reverential towards our policy makers as many commentators are today. But with that historical background, it is impossible for the MPC to make untainted policy decisions today. The MPC may be independent of government, but it is not independent of its history.

I think it is now clear that an extended period of unconventional monetary policy has not fostered the economic momentum that was envisaged. Economists at the Bank, defending the course that it has taken, constantly broach the so-called 'counterfactual'. In other words, critics of policy should cease their reproaches, because they do not know how bad things could have been, had the current policy regime not been adopted. This, of course, is true of anything, at any time. Moreover, the counterfactual itself has no bias. While we may not know how bad things might have been, we also do not know how much better things could have been.

In my view, the extended period of low rates has reduced economic challenge and induced economic laziness. Nowhere is this more evident than in the very low rates of productivity growth that have been evident in all major advanced economies since the great recession. It is productivity growth that generates real wage increases and real profits growth. But negative real returns from cash and government bonds have created the lopsided position in which companies no longer have to compete for capital, so there is no pressure to take the risks involved in embarking on potentially productivity-enhancing capital investment. And investors are kept happy by cash-flow being pumped into dividends.

So, while UK policy makers continue to allow themselves to be haunted by the consequences of past policy mistakes, the US Fed seems to have adopted a more forward looking approach. If the reward is that productivity and growth momentum improve in the US as interest rates rise, other central banks may be jolted out of their policy comas.

First published on 20th November 2017 by Richard Jeffrey, Chief Economist at Cazenove Capital Management.

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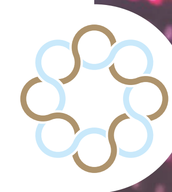

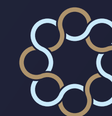

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