Investment Solutions

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Investment Solutions – Market Commentary – May 2017

Will snap election be a game changer for the markets?

Although Brexit and the health service are likely to dominate the general election headlines, it is received wisdom that most of us will vote with our wallets and favour the party that will benefit us the most.

The Pound rallied against the Euro when the vote was announced – making May Bank holidays look more affordable. However, in the run-up to June 8 uncertainty will reign as markets try to anticipate the financial impact of a new government.

Sterling enjoying strong gains is good news for holidaymakers, who can take advantage of favourable exchange rates. The downside is that it saps the overseas revenues for many FTSE 100 companies. Within 2 hours of Theresa May's announcement, the UK's main index fell 2%.

Anxiety among investors could result, in more demand for gold and other traditional safe havens. However, analysts say that hasty decisions based on short-term markets sentiment are ill advised. "Investors must consider whether the election changes the long-term cash-flow generating powers of the FTSE 100's members before they decide whether to take evasive action – or use any sustained market weakness as a chance to buy what may be good assets going cheap" says Ivan Lyons, Managing Director at Investment Solutions.

Jan Kinghorn, Senior Financial Advisor, says that although markets can be jittery in the run up to elections, "this may be different as the polls suggest that the incumbent government is likely to remain in power".

According to David Connor, Director, a recovery in Sterling "is one of the biggest risks facing investors who have shunned UK markets in favour of international funds over the past year – especially those who have piled into the US off the back of the Trump victory". If the pound continues to rally then fund managers might turn to sectors that have been neglected since the Brexit vote, such as food retailers.

US

With 3 months behind him in office, President Trump may be falling short of his intended progress. His executive orders on immigration have been countermanded by the courts, his reform of the affordable care act (Obama care) has been stopped and it is looking increasingly likely that his plans for personal and corporate tax cuts, the introduction of a board adjustment tax and a profit repatriation scheme will be implemented. His infrastructure spending plans (originally $1 trillion over 10 years – to be financed one quarter by the federal government, three quarters by private participation) are still in gestation. In contrast, Trump's executive orders allowing the go-ahead for the Keystone and XL pipelines and nullifying president Obama's climate change efforts while blocking the closure of hundreds of coal-fired power stations and restoring the mining of coal are, so far, his only significant achievement. The business of government is proving harder than running a group of unlisted privately owned companies.

Meantime, despite the strong rally in the stock market, the sale-off in the bond market and the improvement in sentiment indicators, the "hard" indicators such as profits and revenue growth, manufacturing output or real GDP growth have been distinctly lustre. While it is possible that these may move upwards in coming months, there would need to be an extraordinary shift in performance to start to achieve a growth rate of "at least 3.5% and as high as 4%".

Abroad, President Trump has said he will renegotiate The North American free trade agreement (NAFTA), he has withdrawn from the trans-specific partnership (TPP) and he has threatened to impose substantial tariffs on “currency manipulators” to stop the inflow of subsidised and allegedly legal products below market prices.

Meantime, the Federal Reserve has continued with its policy of gradually normalising – not tightening interest rates. This means that the federal open market committee (FOMC) has raised rates in line with what the economy is capable of tolerating, but not enough to squeeze credit (as would be necessary if inflation was a problem).

Key indicators forecast real GDP growth to improve to 2.3% in 2017 and 2.6% in 2018 whilst expecting consumer price inflation to average 1.9% in 2017.

The Eurozone

In the euro-area the near term environment has been and will be dominated by politics – the Italian referendum last December, the Dutch election held in March, the French presidential election in April/May and the German election in September – all against the back drop of extended negotiations over Brexit.

The economic outlook for the euro-area remained subdued in the short term and still far from robust in the long term. Real GDP growth remains steady at 1.7% year on year in Q4 2016 and although headline inflation temporarily increased to 2% in February, it is likely to fall back over the coming months.

Surveying the Q4 2016 GDP data for different economies shows a diverse picture across the single currency zone. Ireland grew by 6.6% year on year, Spain by 3%, Germany by 1.7%, France by 1.1% and Italy by 1.0%, while Greece saw a year on year decline of -1.4%. Despite much better growth of figures in Ireland and Spain, these economies are not large enough to shift growth in the euro-area as a whole to a higher trajectory or to attract employees from other member economies as would happen in a well-integrated currency union like the US or Canada.

The consensus forecast for Eurozone real GDP growth is in 2017 is 1.6%. On the inflation front we would expect inadequate M3 growth to continue, keeping inflation at 1.4%, compared with the consensus figure of 1.7%, both still under shooting the ECB’s target of “close to but below 2%”.

Japan

Thanks to an annualised real GDP growth of 1.2% in Q4 2016, the Japanese economy has now grown for 4 consecutive quarters – the longest run of growth in 3 years. This modest growth rate was primarily the result of increased exports, while real private consumption remains subdued at 1% year on year. The depreciation of the Yen has given a boost to exporters and corporate profits, but is doubtful the increased profits will be passed on to workers in the form of increased wages.

The “Abenomics” policy for reviving the economy via “3 arrows” of monetary expansion, fiscal stimulus and structural reform, has still not delivered any meaningful pickup in the domestic economy, despite being in operation for nearly 5 years. Meanwhile the bank of Japan (BOJ) balance sheet has expanded by nearly 200% since March 2013 when the new monetary policy under governor Kuroda was implemented. Total BoJ assets as at April 3 were 490 Trillion Yen, of which 95% was domestic government debt. It is looking like the BoJ’s design of their QE programme is flawed since they purchased assets from banks rather than from non-bank private sector and they also still buy short term paper. The result is that Japanese broad money M2 has not grown anywhere near enough to produce meaningful inflation or growth.

Meanwhile the Trump administration plans to crack down on economies that they consider currency manipulators. They have highlighted Japan, China and Germany, which all run large current accounts surpluses, for having manipulated their currencies and therefore have not behaved fairly. Whether the administration takes any account of availing action remains to be seen.

We expect Japanese real GDP growth to average 1.1% in 2017, whilst some weakening of the Yen (not domestic monetary growth) will raise headline inflation CPI to 1% 2017.

China and the emerging economies

Figuring out what has been going on in China over the past year has been challenging. On the one hand government spending accelerated from 8% to 18% between late 2015 and the end of 2016, while the central bank lowered some interest rates but kept others stable. At the same time the authorities eased lending standard for mortgages and cut auto sales taxes from 10% to 5%. On the other hand, domestic credit growth in China has slowed abruptly from 20% to 17% year-on-year over the past year, the auto tax was raised again to 7.5% and since November the peoples bank of China (PBC) – China's central bank – has started raising interest rates, allowing the Shanghai 3-month interbank rates (shibor) to rise by almost 150 basis points. In part the PBC has been closely following the US Fed to prevent the Chinese currency depreciating; in part they have been keen to curtail a renewed surge of house prices. House prices in Tier 1 cities increased by 28% year on year last September and were still rising at 22% in February.

On the external side China's exports have continued to be lacklustre, essentially declining since February 2015 (on a 12 month moving average basis in US dollar terms), while imports have only very recently started to recover. Given that the recent upswing in imports may be associated with base effects stemming from commodity price weakness until December 2015, it will be fair to say that Chinese external trade has basically been contracting in US dollar terms since the start of 2015.

Since China is by far the largest emerging market and the biggest buyer of commodities on world markets, the growth – or lack of growth – of China's imports matter immensely to a large number of commodity exporters. Unless China can engineer a steady recovery over the next few months, the outlook for those commodity exporting economies will remain mediocre at best through 2017.

Commodities

We have generally been cautious on the outlook for commodity prices over the past 3 years on the grounds that the recovery in developed economies were still anaemic, while emerging economies were either in recession or had big debt problems that would inhibit recoveries. Therefore the overall demand for commodities would remain weak. However, the recovery of oil and metal prices in 2016 began to suggest that the bear phase might be coming to an end. At the present junction, with President Trump's infrastructure plans still on the drawing board and China slowing its credit injections, commodity prices have not taken off and consequently our forecast remains largely intact.

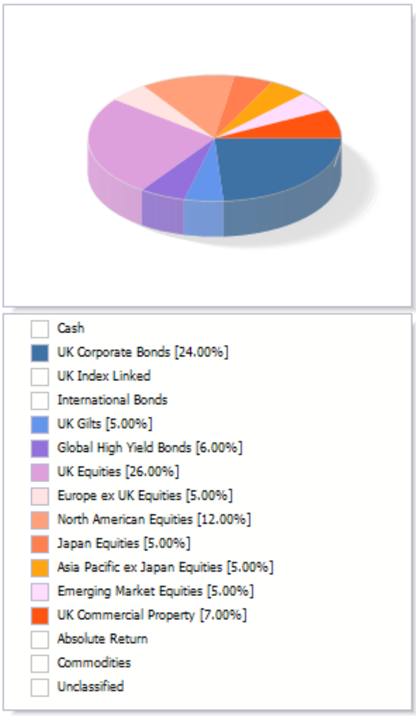
Conclusion

The Trump "inflation rally" has driven equity markets across the developed and emerging world over the past few months since the US election, while at the same time generating a meaningful upturn in longer term bond yields. However, with the new President now meeting opposition to its programmes – notably his contested executive orders on immigration and his attempt to repeal the ACA or Obama Care – there are starting to be significant doubts about his ability to implement other elements of his programme such as the proposed personal and corporate tax cuts.

In every business cycle the value of equities and real estates are fundamentally driven by the level of business activity, in this respect President Trump's inheritance is a singularly favorable one. Banks and households that were over leveraged in 2008/09 crisis have mostly completed the repair of their balance sheets, inflation is low and the US Fed have been able to start normalising short-term interest rates. There is therefore very little risk to a continuation of the current business cycle upswing in the US.

At Investment Solutions, we have always operated a policy of investing client monies for the medium to longer term and in the current market we continue to believe that good active fund managers should prevail. The overriding measure for positive investment returns is diversification. For instance, for a risk profile 5 investor (Balanced risk) our general current asset allocation is:

Target asset mix



As always, if you would welcome advice or further in-house views then please do not hesitate to contact us

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