Investment Solutions

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Investment Solutions – Market Commentary – July 2017

Global Outlook

Global equities are shy of record high's as robust company earnings reinforced optimism in the worldwide economy. All the foremost areas reported their strongest first quarter earnings growth for nearly six years, helped by a recovery in global activity. However, as always, potential headwinds to global growth remain. Elections in Germany and Italy are looming and Brexit negotiations begin against a much weakened UK government, in addition US President Trump's ability to implement his spending and tax-cut plans is far from assured.

Geopolitical tensions, oil volatility and Brexit negotiations are all conspiring to keep markets on the back foot over the last month. The G20 meeting and Donald Trump's visit to Poland flag up the many problems besetting global leaders, from Russia via Saudi Arabia/Qatar, Syria and finally on to North Korea.

UK

Death by a thousand cuts? The UK has managed to manoeuvre itself in to a position where it voted to leave the European Economic Area but without a strategy as to who would govern and what its exit demands were. Then in a deceive stroke a snap election was called, presumably to cement the UK Government's majority and establish a strong and stable (remember that?) negotiating position against the EU. And as we, know this did not go to plan either with a Hung Parliament being the UK election outcome. However, the FTSE 100, 250 and All-share index shrugged these events off, with the FTSE 100 gaining ground up until the last few days where it is still well over the 7000 points hurdle. So thus far the UK economy would seem to be largely undamaged by the potential EU separation, however there are some telling indicators that could lead to more difficult times ahead. London rental yields have fallen for the first time since 2009; city based global institutions are relocating 'teams' back to the EU when their employment contracts are maturing (typically two years), house prices are falling in London and stalling (at best) at the top end of the market elsewhere in the south. In addition to this the economic wellbeing report shows that families' incomes have fallen 2% against the rising tide of inflation swelling at 2.9%. Alongside this, the UK has a weakened government negotiating against the not-insignificant political will of the EU. It is likely to be a slow painful process - let's just hope it's not a death by thousand cuts. Thank goodness for the FTSE 100 and 250 with it's highly globalised demographic, providing some much needed international diversification to the uncertainty of that the UK political class is providing.

US

US job figures (a long term leading indicator in the US economy's health) show that unemployment is at its lowest levels in 16 years standing at 4.3% in May with 138,000 job created in May, however this was less than 180,000 anticipated and knocked confidence in the world's largest economy. Moreover, the US Federal Reserve has expanded strongly in recent times due to the impact of quantitative easing. At some point, this process will need to be reversed. How will the US central bank go about shrinking its balance sheet and will this be disruptive to financial markets? When the Fed starts normalising its balance sheet, they must keep in mind two sets of objectives: (1) on the asset side the end-game is to end up with all investments in US Treasuries and (2) on the liabilities side the aim will be to end up with a balance sheet that accommodates the growing quantity of Federal Reserve Notes and the desired level of commercial bank reserves. When the Fed acquired its portfolio of securities in 2008-14 it purchased most of its securities from non-banks, resulting in Fed payments to these institutions which boosted the level of deposits in the banking system, easing financial conditions and supporting asset values in bond and equity markets. To avoid imposing unnecessary stress on financial markets during the reverse process it will be important to avoid any decline of bank deposits. How this will be managed and what impact this will have on, already high, US equity valuations remains to be seen.

Europe

The French election did not hold many surprises and as such European equity markets continue their advance. Stocks performed strongly in May following as the victory of pro-Europe centrist Emmanuel Macron in France's presidential elections. Economic growth indicators in the euro-area continued to point to a vigorous level of economic activity. A survey measuring manufacturing output stood at the highest level since March 2011, indicating growth in each of the past 47 months. Eurozone unemployment dropped to 9.3% in May, the lowest level in more than eight years (still well behind the UK and US), while buoyant sentiment was registered among consumers and businesses. The eurozone annual GDP growth forecast rose from 1.6% to 1.7% in May. With Greece growing faster than the UK and the US!

In contrast, inflation remained below targets set by the European Central Bank (ECB) with headline inflation at 1.4% in May, from 1.9% in April. Core inflation, a measure that strips out volatile components such as energy and food, fell to 0.9%. And while economic growth data might warrant a small scale back in monetary policy stimulus, subdued inflation level is putting ECB policy-easing measures schedule further into question.

With low inflation and monetary easing still a fixture of the Eurozone we still (much to Mrs May's chagrin) believe this area remains an opportunity for growth within our clients portfolio's – at least over the short to medium term.

Japan

Japan's Topix index posts record earnings and there is credible evidence of strength in the Japanese economy. Preliminary first quarter GDP growth came in at +2.2% quarter-on-quarter annualised, which was stronger than expected, with monthly data for April supporting evidence of a recovery in consumer spending. In addition the Japanese economy is now in third place amongst the world's largest growing economies (G7) with first quarter growth of 0.50% (with Canada and Germany leading the way).

The achievement of record earnings was accompanied by record high dividends as the trend of improved shareholder returns continued. 30% of Japanese companies in raised their pay-out ratios which is a relatively new phenomenon in Japan. The Bank of Japan has moderated the pace of easing measures and this far, this is not caused the yen to strengthen against the US dollar - partly due to the dollar benefiting from expectations of higher US interest rates.

Much like the Eurozone this is an area that still has growth potential over the short to medium term, in despite its many false dawns - the differential from previous 'sunrises' being the aggressive stance of Premier Abe and the programme of quantitative easing to inject capital in to the economy.

Emerging Markets

It was a positive month for emerging equity markets as they outperformed the developed world for the fifth month in a row. Emerging Asia was the strongest performing region with all the equity markets in the area gaining ground. Korea led the gains followed by China with the latter seemingly unfazed by a sovereign bond ratings downgrade by Moody's.

Fears that Brazil's economic recovery could be undermined by a widening corruption scandal in the country had a dampening impact on market confidence. Outside of Brazil, there were gains for the equity markets of Peru, Colombia and Mexico.

Australian equities were rather feeble due to uninspiring corporate earnings, speculation about a domestic housing bubble (again) and a taxation measures. South Korea's equity market was the Asian region's best performer, pushed higher by healthy first quarter corporate earnings and withdrawing political issues. Wages benefited from stronger sales growth, helped by the gradual global economic recovery. India - despite lower than expected GDP growth, India's equity market rose as investor sentiment was assisted by growth on the Goods and Services Tax roll-out. Premier Modi's economic reform continues, despite not being as effective as first portrayed. Finally, Taiwan's equity market reached new highs, led by the Taiwanese technology sector.

China

Chinese investors were unmoved by a sovereign bond downgrade and the Chinese equity market rose on the back of the People's Bank of China (PBC) signalling that has begun to reduce the financial risks that could negatively impact upon market liquidity - as was witnessed in the summer of 2015. On the back of this the yuan strengthened, reducing doubts around currency depreciation and making China the regions the second best performer over the last quarter.

We see this as good news for investors in this area, with concerns around China's ever increasing debt (bubble?) remaining, it is encouraging to see the PBC firstly acknowledging this and secondly and more importantly beginning steps to alleviate systemic risks.

Medium to long term it is hard to see how China could not be an area that investors would not want to have some exposure to.