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Quarterly Investment Bulletin

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General Economic Overview – Quarter Three 2016

The third quarter saw a market recovery following the short-term shock of the vote by the UK to leave the European Union at the end of the previous quarter. Whilst markets reacted negatively in the initial aftermath of the vote, they were relatively quick to recover as the economic data coming through from the UK and other western markets was not as negative as first anticipated. There has of course been some volatility along the way, and this has been influenced by a number of factors, including the likely raising of US interest rates and the strength or weakness of commodity prices, particularly oil. The summer months are often the most difficult to judge in terms of market trends as trading tends to be lighter and there are many investors and policy setters taking annual leave.

The current economic environment and the way in which central banks are supporting a loose monetary environment leads many investors to believe that we are in a 'lower for longer' environment in terms of both economic growth and inflation. For many this period has been extended further into the future because of the slower growth in areas such as China, and an unwillingness amongst central banks to tighten policy under such fragile conditions. Cyclically, growth remains lacklustre and inflation subdued. On a multi-year outlook, demographics, debt and income inequality mean that the likely path for equities will be much shallower than we have been used to in the past. There is a 'policy divergence' between major central banks – in the US, the recovery is much more advanced, yet the Fed is still likely to pursue a gradual rate tightening strategy whilst in Europe, Japan and the UK, monetary policy is likely to remain very accommodative for the foreseeable future given the additional growth headwinds.

The most recent Bank of America Merrill Lynch survey of money managers, which has been running since 1900, indicated that 54% of investors felt that bonds and equities were overvalued causing a number of them to hold higher cash levels at the beginning of September. Many indicated they would prefer to hold cash rather than low-yielding equivalents such as government bonds. The fact that yields have fallen so consistently for so long means that there is little scope for further capital gain, but there is greater risk in holding such assets if inflation and then interest rates start to rise to levels seen before the financial crisis. Very few managers are predicting any significant increases in rates in short term, but the risk of yields increasing is causing some to shorten duration in their portfolios in anticipation of this. This lack of current yield does have knock-on effects, and the hunt for yield has heightened following yields falling into negative territory in Europe and Japan. The fear that central bank monetary policy is becoming less effective was a catalyst for some of the falls in September as there was no confidence that this would be replaced by fiscal policy. On a positive note the survey also indicated that there was greater optimism that we would get higher global growth next year.

The low return environment does not rule out making gains, and the equity risk premium may well provide 3-4% return above cash but the equilibrium is fragile and should economic conditions deteriorate more, then government support may need to be forthcoming, possibly in the form of fiscal policy rather than a continuation of loose monetary policy. This will, no doubt, be accompanied by periods of volatility which may be uncomfortable for investors given the levels of anticipated growth.

Equity Markets Overview

This has been a strong year for equity investing which is ever-more surprising given the start to the year and the fall in markets following the problems in commodities and fears over Chinese growth. The strongest gains for a sterling investor have been in emerging markets and Asia where a stable dollar and greater confidence in their economies saw global investment increase.

UK

The initial shock of Britain's vote to leave the EU has now passed and there are some signs of businesses and consumers regaining composure in the short term. The Bank of England's strong policy response cutting rates and boosting QE has had the short term positive effect of devaluing the currency significantly – historically many stock markets perform strongly in local currency terms after a devaluation and the UK has been no exception to this. Whilst in the immediate aftermath of the Referendum indicators of economic activity plunged to their lowest levels since the Financial Crisis, there are signs of a bounce back in both manufacturing and services. In general retail spending and house prices have held up, although the former has yet to suffer from the increase in inflation that will occur from a fall in the currency. Recent economic data has seen a shift in forecasts from many investment banks, with now a slowdown in growth rather than outright recession predicted. Whilst this is good news in the short term, it is not necessarily a guide to the long term prospects for the UK. Companies will need to be convinced that the UK will be a stable environment to do business, and business leaders and external countries have warned new Prime Minister May about the importance of retaining access to the single market. Part of the market optimism may be based on a belief that a 'soft' rather than a 'hard' exit from the EU will occur. If negotiations are lengthy, uncertainty will be a drag on corporate capex in the UK and at the moment there is still little clarity on the process, timetable or likely outcome of the exit. Concerns for the service sector are wider and the worries over passporting of financial services have been well documented. Intra-EU service trade has been aided by the adoption of one Regulator, and a divergence of regulatory regimes between the UK and the rest of the region would hamper this pillar of strength in the UK economy.

US

The most recent issues for the US economy have revolved around the likely path of interest rates and the rhetoric coming from the Federal Reserve, current equity valuation levels, the chances of a Trump presidency and the implications of this. There have been a number of occasions in the past weeks and months when policy seems to have shifted and differing opinions have been offered by members of the rate setting committee. This has been driven by stronger US economic numbers and in particular employment, pushing for higher rates, but restricted by the state of the global economy which is in a generally weaker position. The upcoming election is clearly a headwind for markets and may well have an effect on if and when interest rates are next raised which looks more likely to be in December based on the latest Fed statements.

The reality of the US market for most observers is that it is highly valued compared to other stock markets around the world. At just over 18x earnings, today's US equity valuations are modestly above historical averages but this is at a lower GDP growth rate. Earnings expectations have in fact fallen since the beginning of the year with different sectors experiencing different headwinds. After the strength of the US stock market in recent years, prospects for further gains must rest entirely on higher earnings, rather than increased monetary stimulus as the Fed contemplates when, rather than if, the next interest rate rise will occur. Market confidence suggests that some participants believe brokers are too bearish and that profit forecasts for US companies are therefore too low. There has been a shift in style bias in the last month as the support of growth stocks has waned and more value-based opportunities have come to the fore, which has seen a change away from the highly valued defensive stocks. The dollar has remained stable which has helped emerging market stocks to gain some momentum and even a raise in rates in December 2016 is unlikely to strengthen the dollar too much. Inflation however, remains subdued and, although there is some pressure from rising wages, the level of growth does not seem strong enough to cause any serious pressure. Any policy to increase rates will remain slow and steady but the start may be sooner than expected if economic growth improves and/or inflation becomes more of a problem. The Fed continue to take an interest in global economic conditions and are factoring this into their policy. The US still seems to be leading the world in a low growth environment but any consistently weaker data may well cause other markets to react negatively.

Europe

The focus this quarter has been on how Europe responds to the UK vote to leave the European Union. Brexit has led to some discussions about the future of the EU given the potential rise of populist politics in several European countries, notably France and Italy, and with elections being held in a number of countries through the remainder of 2016 and into 2017, the results should be closely monitored for evidence of any acceleration in movements towards further possible European referendum votes. This is very much against what the European Union leaders are trying to achieve and they have stated their resolve in making the EU stronger going forward.

Prior to the UK referendum, sentiment towards European equities was positive, as evidenced by the June Bank of America Merrill Lynch fund manager survey. This quickly turned negative with the July data but improved again in August. With inflation remaining relatively flat and growth still relatively subdued, albeit improving, the ECB may decide to take further monetary policy action but it is debatable as to how effective this will be unless they do something slightly different. Also, very low interest rates are negative for the financials sector, particularly banks, and there are already concerns about the financial stability of some of the Italian banks and the amount of their non-performing loans, which may have a further effect within the sector. The recent problems surrounding Deutsche Bank serve to illustrate that this is a Europe-wide issue.

Corporate earnings remain well below their trend levels and lag behind the US market and profit margins remain well below their historic peaks. The previous weakness in the euro, particularly versus the US dollar, had been a benefit, particularly to domestically-focused sectors, but recent euro strength and US dollar weakness, due to the lack of interest rate movements, has been negative. There are additional concerns regarding the effect of Brexit on European company earnings.

A continued focus on financially strong companies plus a balance of companies with international and domestic exposure could prove to be a relatively sound strategy within this asset class alongside a balance between value and growth. The market does look reasonable value versus other major equity markets, particularly US equities, but this alone will not be enough to propel it forward.

Asia

With the slowdown in other parts of the world, Asia has actually reaffirmed its position as the fastest growing global region. After a period in which the relative growth rates of Asia and the developed world converged, the reverse is happening this year with emerging Asia outperforming the global economy by a wider margin. This may have an influence on fund flows, as over the last five years most global investors have been turning cooler on emerging markets. Asia has now come to terms with a fall in export earnings and the decline in commodity prices, together with the slackening and rebalancing of demand from China. Some Asian economies have benefitted from increased FDI flows as Chinese labour costs increased.

Across the region exports were barely positive in the second quarter, but domestic demand has grown at its fastest rate since the final quarter of 2012. Within the ASEAN region and India, consumers are generally under leveraged and there remains scope for greater credit penetration in these economies. This is combined in many countries with robust population growth and rising incomes. Within Asia, consumers in South Korea and Malaysia have relatively high debt levels, whilst debt appears to have peaked at the consumer level in Thailand. Over the next few years selective parts of Asia look likely to once again top the leader board in terms of global growth and the Asian consumer story is still far from over.

Within the ASEAN region Indonesia is the largest economy and this grew by 5.2% in the second quarter of the year, which was its fastest year-on-year expansion for ten quarters. The Philippines has continued to grow strongly, expanding by around 7% in the second quarter. India now ranks 7th after France in Global GDP ranking and posted an official 7.9% growth rate in Q1.

The stabilisation seen in the Chinese economy has been a further positive for the global economy in recent months. Whilst this has been good news in the short term, it does mean that hard decisions about capacity reductions in heavy industries such as steel and coal have been put off to some degree. Chinese SOEs remain hamstrung by their heavy debt burden and industry consolidation will result in job losses. Politics in China are awash with rumours ahead of the naming of the new Politburo in October so there are unlikely to be any measures taken that will reduce growth in the short term. Next year China could refocus on reform resulting in a slowdown in the economy and this could also have geopolitical indications as very often a country seeing economic pressure will cite an external threat as a reason behind the need for austerity. There remains the possibility of increased tension in the South China Seas where external expansion could lead to conflict with the United States. Both US Presidential candidates are likely to take a harder line with China than the Obama administration has done.

Japan

This year, policies from the Bank of Japan have proved counter-productive, as an initial move to lower interest rates produced an unexpected reaction in terms of a stronger currency and weaker stock market. Whilst the Bank of Japan has verbally promised to go further in applying unconventional measures, how effective these would be remains to be seen, although the Bank of Japan is likely to be the first of any major central bank to resort to something such as helicopter money. The debate about the strength and purpose of the reform process in Japan continues with year to date numbers challenging many investors, as the market and the currency are both unnerving investors. A stronger yen has been a reflection of weakening global confidence as expected growth rates have been reduced alongside fears over Chinese growth.

Generating increasing inflation continues to be a problem, as evidenced by the latest 0% figure, and the Bank of Japan has already pushed out the expected date for reaching its 2% target back. Many investors and commentators are expecting an announcement of further monetary stimulus in the coming months following the move to cut the benchmark interest rate to negative in January and the poor Q4 GDP growth figure. Should this occur, and in sufficient size, it could be positive for markets and negative for the currency but expectations may have already been priced in and, as in Europe, each subsequent QE expansion seems to be having less of an effect.

Emerging Markets

The strength in emerging market equities has surprised some given the early strength of the dollar in 2016 but this momentum has been stabilised by slower global growth and a more globally conscious Federal Reserve that appears reluctant to raise rates. The other major issue for emerging economies was the weakness of commodity demand and therefore prices, but this has also stabilised of late and with an oil production agreement from OPEC likely, the signs are more positive in this area generally.

After a difficult period following the 2013 'taper tantrum', Asia is now leading a gentle recovery in emerging market GDP growth rates. India is seeing a pickup in domestic consumption aided by significant increases in salaries granted to public sector workers earlier this year, together with a good start to the monsoon. Some countries in South East Asia (ASEAN) are also seeing a pickup in their economies.

The recovery in areas weakened by commodity deflation has been significant in 2016. Although the Brazilian economy is in recession, political change and a belief that the worst has now passed, means this has been one of the world's best performing markets year to date. Investors in both debt and equities in the region were attracted by record low valuations and a hunt for yield. Like many parts of the emerging world today these markets are no longer a homogenous group – the challenge for investors and fund managers is to work out which are the most attractive ones.

Fixed Interest

In some respects we could repeat comments made in our last quarterly review – where the continued strength of bond markets, both sovereign and credit, is surprising many investors this late in the cycle. The core reason is of course the same in that governments and more specifically central banks are continuing to support the bond markets by purchasing debt to maintain liquidity in the system and trying to encourage business lending. In September we saw some increase in yields as concerns about the effectiveness of monetary policy and the potential for more fiscal intervention was discussed at the G20 summit. With yields so low there seems little scope for further capital gains and a number of managers have been positioning their funds for this increase in yields to continue albeit at a slow and gradual pace. Any hint of a recession and we are likely to see more central bank support, particularly in the UK and possibly Europe, although additional stimulus was rejected at the last meeting of the ECB causing some further concerns for the European banking system.

It has not helped that investors looked to exploit central bank policy by not only purchasing what central banks bought but also trying to anticipate where they might go next. This partly explains the market reaction in the immediate post-Brexit period. Central bank activity also repressed volatility in financial markets, which resulted in the fulfilment of the initial desire of central banks to encourage investors to take more risk. There is an argument that this has now gone too far and investors who should, by the nature of their financial position, be low risk are encouraged into assets with potential significant downside in capital values.

There may also be a realisation that zero rate policies do not work for large sections of commerce or society, with both banking and insurance company business models struggling in the current environment of ultra-low rates and flat yield curves. Consumers may also be forced to save more as the capital needed to generate returns, particularly from low risk investments, has increased substantially. The current level of interest rates does not really suit retirement, yet not everyone will be able to continue working forever. US officials are also undoubtedly concerned about their lack of ammunition in any further economic downturn and, whilst not ruling out the possibility of further unconventional measures, there is probably a desire to try and normalise rates to some degree when the opportunity arises. There has also been debate at the Fed about whether the inflation target should be made more flexible in an attempt to raise the level of equilibrium interest rates in the economy.

This asset class remains the most difficult to invest in during the current environment as despite its lower risk characteristics, capital values have risen so much that should inflation and interest rates start to rise many investors could see a substantial decrease in their asset value. Replacement options are not easy to find and are often complex and equally risky.

Property

The impact on the direct UK commercial property market of the UK's vote to leave the EU was represented by the performance of property indices which have been negative to the end of July. Further evidence is the fall of over 4% in values seen by CBRE Group Inc., the US real estate company, including over 6% in central London offices where the impact was expected to be greatest. The real impact of a possible vote to leave had started to be felt prior to the actual vote when many open-ended property funds moved their pricing basis due to negative fund flows, as investors reduced their property exposure ahead of the vote. Many investors had been overweight commercial property for some time and this had served them well but with the reduction in expected returns, some chose to take profits and reduce their allocations, which was not necessarily a negative view on the asset class as a whole.

The vote result itself led to a significant increase in the number of investor redemption requests from open-ended funds to such an extent that some funds decided to suspend trading, most funds applied some form of fair value market adjustment and, where applicable, the pricing basis moved to reflect the (now more significant) negative fund flows. This led to significant falls in the value of property fund holdings. Most of the suspended funds remain suspended but there have been large reductions in the level of market value adjustments applied across most funds over the very short term, suggesting some return to normality.

The fundamentals of the asset class have not changed that much, but there may be a valuation impact on those properties, sectors and regions that have seen the highest price rises over the last few years, which would include Central London. To counter this, however, the large fall in the valuation of sterling versus overseas currencies may make property more attractive to overseas investors. Returns are expected to remain reasonable through 2016 but with absolute returns much lower than recent years. Returns are increasingly likely to be driven by income with capital growth very limited and rental growth becoming an increasingly dominant factor for performance. This asset class remains a solid option for income seeking investors and for diversification purposes but investors have to take account of the current liquidity situation. The yield gap for secondary markets versus prime property remains attractive but individual property selection will remain important here.

Returns from the REIT/property securities markets were subdued in August after a strong July with the global index producing a negative return. The negative return from the US market had the greatest influence as, although growth has been relatively weak, there is the feeling that interest rates will rise sooner than was expected a month or two ago. UK and Europe were positive, as the UK cut interest rates and Europe may be set for more QE due to weak economic growth. The sector is sensitive to interest rate policy, so all discussions about interest rates and monetary policy are likely to be key drivers of this sector's performance over the coming weeks and months, perhaps even more so than fundamental economic factors.

Summary

Since the Brexit vote markets have rallied strongly with many investors perhaps complacent about the influence central banks can continue to exert on asset markets. More recently there have been higher levels of volatility following comments by some US Federal Reserve governors indicating they would like to see higher interest rates and the ECB stating there was no intention at present to further extend the QE programme.

The actions of central banks have been of huge benefit recently to holders of financial assets, as unconventional monetary policy has delivered low volatility and profitable correlations. At the end of 2015 there were some signs of a return to more fundamentally driven markets, but this was delayed as investors' perceptions of the market implications of Brexit were for rates to stay lower for longer – this is now a consensus view, although there are some reasons to question how long it will last – if the US does raise rates and the EU does not significantly extend QE, financial valuations will be more influenced by economic and corporate fundamentals. Another factor for investors to consider is the crowded portfolio positioning driven by a thirst for yield, and the focus on high quality and visible corporate earnings. 2016 has seen the omnipotence of Central Banks questioned by markets and now there is an increasing recognition, including by the Central Banks themselves, that unconventional monetary policy has reached close to its limits. This is not just in terms of its ability to generate self-sustaining economic growth, but also in terms of the unfavourable consequences of zero and negative interest rates for the health of financial institutions. Banks, insurance companies and pension funds do not have business models that work in today's interest rate environment.

There is a need for investors to remember that there is now general consensus about rates remaining lower for longer, and a change in belief by Central Banks that extreme monetary policy measures are becoming counter-productive could lead to levels of increased volatility and sector rotation in markets. Political leaders and Central Bankers have observed the rise in populism fuelled by the correct belief that QE has done little to help most individuals and any change in market perception on inflation or interest rates could lead to a very interesting fourth quarter for financial assets. QE has flattened the yield curve, increased fiscal stimulus could steepen it, changing the market's performance drivers.

A market where both bonds and equities move in tandem makes true diversification hard to achieve and careful fund selection and portfolio construction is necessary to mitigate against this. In the fixed interest space, strategic bond funds prepared to take measures to defend capital values by shortening duration may well fare best. Within absolute return, funds not reliant on bonds as a sole hedge against equity volatility may achieve the best diversification benefits. In equities, whilst a cautious stance seems justified certain lagging markets and sectors have the scope to deliver positive returns over time.

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