RSMR

PRIVATE & CONFIDENTIAL

Grayside Quarterly Investment Bulletin

January 2018

General Economic Overview – Quarter 4 2017

The level of synchronised recovery in the global economy and the performance of global stock markets has surprised many investors in 2017. Monetary policy has remained accommodative as inflationary pressures, especially wage growth, have been muted and opinions as to the extent of an inflationary pick up in 2018 remain polarised with many different opinions across the investment world. This 'Goldilocks scenario' of growth neither too hot nor cold has provided investors with strong returns in 2017 – the US bull market became the longest on record in March 2017, surpassing the 1921-29 period. Long bull markets often cause concern but the length of the expansion needs to be seen in the context of it being borne out of a Global Financial Crisis. Academic research suggests post banking crisis economic recoveries are always more muted than a typical economic expansion and whilst the recovery has been long in duration, the pace of expansion has been moderate with, as a result, few inflationary impulses. This, combined with globalisation, automation and other disruptive technologies has left the global economy with few clear imbalances. It can be argued that without a boom it is harder to have a bust and formal Federal Reserve Chairman Ben Bernanke argues that there is no evidence that an economic recovery is likely to stall just because it is long running.

The key influence on this continued growth in company values has clearly been the economic backdrop, which by February of 2017 was pointing to a broad global recovery and importantly, for the first time since 2009, one which was not US centric. As it became clear that US expansion was not the only source of global growth, US$ strength started to fade, which had important and positive implications for Latin America and particularly Asia. A strong US currency is always a negative for the Asian region as it puts upward pressure on interest rates which means liquidity support for Asian stock markets falls. US currency weakness allowed local Asian currencies to appreciate versus the US$ and countries were able to ease monetary conditions supporting a pickup in growth. One of the other key factors in this period has been the continued influence and pressure placed on traditional industries by disruptive technologies. This is an age of disruption which has several dimensions as has already been seen in economics/markets, where non-normal or unconventional monetary policy has disrupted valuations. Disruption to a typical economic cycle has continued to be seen in 2017 where, despite a US recovery and a significant rebound in growth in Europe and China, inflationary pressures have remained muted with a lack of significant wage growth. Disruption to traditional economic models, together with globalisation and automation has continued to weaken the position of labour versus capital, allowing loose monetary policy to continue, with liquidity a significant positive for markets this year.

Another factor in maintaining investor confidence has been a lack of volatility in markets. In the autumn, the volatility of the US stock market hit its lowest level since the 1960's, taking the Vix index to its lowest ever reading, but this has not just been a US phenomenon, most markets have seen reduced volatility and whether this period ends with a bang or a whimper is a question on many investors' minds. Current conditions support the status quo but 2018 has the potential to be a lot busier in this respect. Geopolitics may be the catalyst for a change in 2018, as was expected in 2017 but whilst tensions rose in China and North Korea it did so without denting investor confidence. While events in the South China Seas have now settled down, 2018 is likely to see continued cat and mouse tactics by both the US and North Korea with the main risk being a miscalculation by any one side.

Equity Markets Overview

Investors this year have seen positive gains from a range of asset classes and regions, with equities making particularly substantial gains – the MSCI World Index showed a 12% return for sterling investors but Chinese and Asian investors saw a 25-35% return. Not all sectors or stocks rose, the best returns have been in selected sectors and regions, for example in the US the Nasdaq has seen the strongest returns led by the tech sector and within that the FAANG stocks of Facebook, Apple, Amazon, Netflix and Google.

Although markets had entered the year not looking cheap, an improvement in economic fundamentals in terms of the growth outlook, with the world seeing the most synchronised recovery in the post-crisis period, but without the threat of significant monetary tightening, has seen stock market gains continuing for far longer than valuation oriented investors expected. This had occurred both in 1987 and 1999 and investor confidence is a powerful force. It is also important to remember that the stock markets themselves can create their own propaganda, with rising share prices increasing not only investor, but also consumer and corporate confidence as people react positively to higher share prices. 2017 has certainly been a year when greed as an emotional factor has outweighed fear.

One of the most challenging aspects of markets today is valuation, as by most historical standards markets trade at levels between fairly valued and expensive and this encompasses not only equities, but also government bonds and credit. Traditional valuation metrics for government bonds, for example, would see investors require a real yield or return above inflation. The area of the market where there is justifiably the most concern over valuation is the United States, whereas outside of the States cyclically adjusted market valuations in areas such as Europe and Asia look more reasonable.

UK

It is increasingly difficult to talk about the UK without mentioning the negative effects of leaving the EU, although there have been more positive signs of late in terms of the negotiations. The IMF has indicated that the UK economy is slowing down and, although 2016 was stronger than expected, the growth levels have come down in 2017. Import prices have had to rise given the fall in sterling with forward contracts gradually running out, leaving the economy expanding at a quarterly rate of 0.5% and a likely growth rate of 1.5% over the whole of 2017. Food has had the largest impact with prices running at an annual rate of 4.4%. The slowdown has been led by the decline in consumer spending although this has not fallen quite as much as expected thanks to increased borrowing which in itself may be a worrying factor. The most recent data showed that household finances have been in the red for four consecutive quarters for the first time since records began in 1987. There are positives however – unemployment is at its lowest for 43 years at 4.3% although this may suggest that the efficiency of labour or productivity has reduced. A more recent Institute of Directors survey of small and medium sized businesses indicated that they were reasonably confident about 2018 with only 17% being pessimistic.

How households now react will be under careful scrutiny in 2018 after most of the sterling related price rises have now been passed on in the shops. Initial data from the Christmas sales has not been encouraging but online data may adjust this upwards (as with recent Next plc results). Economist opinions differ on the 2018 outlook with some being more positive, depending on how the EU negotiation progress. Any improved certainty would definitely help companies firm up investment plans for the UK which is a core factor in improving productivity and efficiencies for a competitive global environment. One underlying positive for the UK economy is that European expansion is gaining pace and Europe is the UK's largest trading partner.

US

The immediate post-Trump rally had seen significant sector rotation, but this reversed after the first couple of months of the year as forecasts for US interest rate increases were pulled back. The Trump agenda failed to deliver significantly higher growth and inflationary pressures remained remarkably muted. Some pro-growth measures such as tax cuts and higher infrastructure spending were pushed forward in terms of delivery until 2018 and so, although interest rates in the States are rising, and there has been a reversal of the post-Brexit UK rate cut, monetary policy globally continues at levels which historically would be considered to be highly stimulatory. This has allowed all markets to continue in a sweet spot dynamic, where growth is neither too strong nor too weak and as we move into 2018 investor expectations are that this 'Goldilocks' outlook will continue for a good while yet.

While Donald Trump may have been elected with the slogan 'Make America Great Again' the lack of impact of his policies to date in boosting growth (and therefore inflationary pressures) have succeeded in making the S&P great again. As fears of a rapid tightening of US monetary policy receded, the US currency lost its position of strength boosting the overseas earnings for US multinationals. US growth continues to push ahead despite the lack of stimulus that was expected and the fundamental data remains positive.

The latest tax cuts approved by Congress look attractive but they have been heavily criticised for helping the wealthy corporate sector and not 'main street' as was initially suggested in the Trump campaign rhetoric. At the moment the president is deeply unpopular at home and abroad and the 2018 mid-term elections may illustrate how unpopular.

The area of the market where there is justifiably the most concern is over valuation in the United States with a cyclically adjusted price earnings multiple (CAPE PE) around a two decade high. In March 2017 the US bull market became the longest on record, surpassing the 1921-29 period and in 2018 the US economic expansion, if it continues, will hit a record in the length of duration of economic upturn. This does create uncertainty for some investors as to when it may end but as noted before the backdrop is different.

Europe

Europe has been a highlight of 2017 with the recovery seen to be reaching all areas with only a few exceptions. The global financial crisis in 2008 followed closely by the sovereign debt crisis in 2011-2012 had major ramifications on the region's economic activity and took a heavy toll on its financial markets. These events have led to both structural and economic reforms across the region, resulting in a European institutional framework and a financial system significantly more robust than it was before. Ultimately, the region has emerged strengthened and since late 2013, a tangible economic recovery, largely driven by domestic factors has developed.

Unemployment in the Eurozone has been gradually ticking down for the last three years, in July 2017 reaching its lowest level since 2009, and sentiment among European consumers and businesses has climbed to a decade high and is acting as a tailwind for investment and consumption in the region. The most troubled areas of Europe such as Spain and Ireland have seen significant recovery. Areas of weakness include Italy and of course Greece but even here there is improvement. Second quarter 2017 GDP data showed Spain growing at its strongest pace in almost two years. Exports and investment have led France to its strongest continuous GDP expansion since 2011, while the Netherlands posted the fastest GDP growth since the end of 2007. European corporates have been reporting healthy earnings growth, helped by the accelerating activity momentum and improving profit margins. Importantly for 2018 European markets still look to be at the cheap end of the spectrum and metrics such as the long-run CAPE (cyclically-adjusted Price Earnings ratio) show there are definite discounts for areas in Europe. Interestingly the risk premium that investors are demanding to invest in Europe is roughly the same today as it was in the crisis period. Europe looks to be a strong area for investment in 2018.

Asia

Asia has been the beneficiary of a number of positive economic influences in 2017 which have helped markets achieve significant growth. The most obvious has been the broader economic recovery led in the region by the strength of the Chinese economy which has benefited from greater stimulus in 2017. The other significant factor has been the relative strength of the currencies against the US dollar which has been stable in 2017 – a stronger dollar puts pressure on interest rates in the region which means support for markets weakens as liquidity reduces. Energy costs have also helped those Asian economies that import oil and other resources such as China but has had a more negative effect on exporters such as Indonesia and Brazil.

China is the leading economic power in the region and will continue to be the barometer in 2018 – it has challenges, particularly in using its capital productively, but it also has the will and the means to address them. Demand management has become noticeably more adept and the consolidation of power in the hands of Party Chairman Xi Jinping is likely to see an intensification of the efforts to reform the supply side of the economy via changes to state owned enterprises. In addition, financial sector reform is likely to continue at its current pace. Local authority finance has been addressed, measures to improve the efficiency of pricing in capital markets are now in place and the focus has shifted to financial regulation more generally and the shadow banking sector in particular. Technology stocks have helped power the growth in the stock markets with Tencent and Alibaba leading the charge. The new economy looks set to continue to expand in 2018.

India continues to have huge potential and is in a more stable political phase but with elections in two years' time the government will want to ensure economic growth continues supporting re-election.

In the Association of South Eastern Asian Nations (ASEAN) region, there is increasing positivity towards Thailand. It is anticipated there will be a stable term for the new government, which would be beneficial for long-term economic policies. In Indonesia the expected uptrend in consumption did not materialise although given the strong demographic advantages the long-term prospects of this market is favourable. Elsewhere, Taiwan and South Korea have recently benefited from earnings upgrades in the technology sector, driven by strong demand for memory and dual cameras and we have seen further evidence of better corporate governance policies in Korea which is clearly positive for domestic equities.

Japan

Prompted by monetary stimulus from Mr Kuroda and fiscal stimulus from Mr Abe, demand has grown steadily in Japan. Unemployment has fallen to its lowest level in 24 years as robust economic growth leads to a deepening shortage of labour. This highlights the most worrying longer-term factor for corporate Japan which is the working age population is in decline. Labour shortages have however been slow to generate inflation which the BOJ has a target of 2% and which is currently 0.3%. The largest factor is the lack of pace of wage increases. Mr Kuroda believes that previous experiences of deflation has made businesses reluctant to increase prices and workers to demand higher wages. It is believed that the BOJ will continue to maintain its stimulus to support the shift to higher inflation in 2018.

Investors in 2017 seemed to have ignored any longer-term issues such as labour tightening as the Topix is up more than 20% (around a 26 year high) and the index that tracks the Tokyo second section (TSE2) is up 37% which reflects the confidence that corporate Japan has built since the recovery phase started in 2012. Based on current economic policy and monetary stimulus the prospects for the Japanese economy and stock market are positive for 2018.

Emerging Markets

Emerging markets have been another bright spot for investors in 2018 as the stock markets have rallied around the stability of global growth and the more stable geopolitical environment.

Since the start of 2017 we have witnessed the unravelling of the initial ‘Trump bump’ trade as financial markets scale down their expectations of what a Trump administration may achieve. The US dollar has lost about 10% of its value against a basket of currencies and emerging equity markets have rallied strongly since January 2017. Indeed, the latter have outperformed their peers in the developed world every month this year, a feat never previously achieved. Mexico is a good example of how this perspective has changed. The market had pulled back some way – not hugely in peso terms but in dollar terms – as the currency reacted negatively to Trump’s campaign rhetoric, but markets tend to overreact and can bounce back strongly as has been the case for Mexico.

Emerging market debt remains one of the last available sources of attractive yield and diversification but, as inflows continue and valuations rise, the relative attractiveness of the asset class does require a note of caution. China has drastically reigned in its credit expansion, US dollar liquidity is set to tighten significantly into 2018 as the Fed reduces its balance sheet, and growth momentum is showing signs of having reached a peak so a more cautious stance is warranted as we move into 2018.

There is a broader cautionary note for investors in both EM equity and debt as they need to consider the rising beta component of returns. Passive flows into EM debt comprised around 25% of flows into the asset class as of November 2017, and, whilst still below EM equity passive flows (60% of the total), this increasing share will likely push up the beta component of returns for the asset class. In a downturn, the largest constituents of the benchmark could be hit very hard if we start to see outflows from some of the large passive vehicles.

Fixed Interest

The one area of negative return across the key asset classes has been in Western government debt, particularly US treasury bills and UK gilts. Given the two central banks have been raising rates this is perhaps not surprising although more unusual is that the general return from the asset class has continued to be positive overall, with credit delivering positive returns thanks to the reduction in spreads over the year. High yields debt and emerging market debt have proven to be the greatest sources of return in 2017 but both should be looked at cautiously in 2018 given the tightness of spreads and the gradual tightening of monetary policy in western markets. Credit markets tend to be sensitive to material shifts in monetary policy. In the past, credit spreads have typically started to widen between 6 and 24 months before a more general equity market peak. The starting point is one of tight credit spreads, supported by improving corporate fundamentals and investor appetite for yield. We are confident in the former, but liquidity could prove to be more challenging and the risks are asymmetric.

Given the broader macroeconomic momentum, corporates have been doing well recently, showing good growth in both revenues and profitability. From a credit investor's standpoint, this has reduced the amount of leverage companies are using, illustrated by the rising number of credit rating upgrades (an improvement in the upgrade to downgrade ratio), in both the US and Europe over the last 18 months. Despite tight spreads, investors are still clearly showing yield-seeking behaviour and the low interest rate environment is still pulling investors into the higher yielding segments of the market, thereby pushing spreads tighter and prices higher. There is therefore some potential for spreads to tighten further but our cautionary view on this prevails as there is so little margin to make gains.

It seems unlikely that rates will move quickly upwards and that they will reach more than 3% before the peak of the growth cycle is reversed. Most investment managers are avoiding government debt and investing selectively in credit, cash and alternatives to build a diversified spread of holdings. Consensus suggests that rates are likely to rise from here, but many investors have been wrong for the last 18 months with short-duration strategies dragging down many mixed-asset portfolios. Those with a more balanced duration strategy have benefitted with small gains being made in 2017.

A secondary threat is liquidity in bond markets which have been much less liquid since the new banking rules came into place following the financial crisis. Concerns have been raised for some time by investors that the new regime has not really been tested in a stressed environment but little can be done about this at the moment other than holding fewer non-investment-grade assets.

Fixed interest assets should not be dismissed because of the potential for monetary tightening, as they can provide a safer haven than many other assets should stress re-emerge in global markets. Many managers have moved to a more defensive stance of late in anticipation of a correction of some kind but this has proven to be a negative for relative portfolio returns.

Property

The physical property market remains relatively stable, despite the continued uncertainty surrounding Brexit. Values fell following the referendum, with city offices the worst affected but offices have since witnessed a solid rebound and over 2017 capital values have increased. Including rental income, which grew modestly over the six months, offices recorded a total return of over 5%. It is unclear at this stage the scale of any relocation of financial institutions to other European business centres such as Frankfurt, Paris or Dublin.

This asset class remains a solid option for income seeking investors and for diversification purposes but there is ongoing concern about the underlying liquidity, especially in an open-ended fund structure, given the events of 2016 and the cash levels of individual funds. The yield gap for secondary markets versus prime property remains attractive but individual property selection will remain important here and any market downturn is likely to have a greater impact on the secondary market.

The global REIT/property securities market is sensitive to interest rate movements and expectations and a close eye will be required on this. The direct UK commercial property market will continue (to some extent) to be influenced by the ongoing Brexit negotiations and the ultimate movement in sterling and returns will be driven more by income with limited capital growth.

Summary

The current sweet spot for equity markets is likely to continue during the first few months of 2018 at least, but investors still need to be aware of what are likely to be important longer term drivers of market levels – fundamentals, valuations and sentiment. There is no doubt this year has seen an improvement in economic fundamentals across the globe, with a recovery spreading out from the States to include Europe where the periphery has actually led the core and the significant improvement in Chinese nominal GDP rates not only helping Asia, but also the global economy. Whilst this is all positive, there is little margin of safety in markets due to full valuations with unconventional monetary policy bringing forward the financial, if not the economic, cycle as investors have bid up risk assets in a zero rate world. High levels of leverage mean that as and when an economic downturn occurs, although this could still be a number of years away, operational gearing for some companies will have risen significantly. One note of caution is that over the course of 2017 the belief in an ultra-long low inflation cycle has become more consensual and there are now many strategies/approaches explicitly or implicitly betting on a continuation of low market volatility. Whilst completely accurate data is hard to get there could well be a significant amount of money which would need to abruptly change direction if volatility increased meaningfully. If the 'goldilocks' environment appeared under threat a sharp sudden market setback could occur.

As the synchronised global recovery has spread, equity markets in Asia, the emerging world and Europe have played catch-up and in US$ terms have been some of the best performing regions this year. Credit has outperformed government bonds as stronger economic growth has allowed default rates to decline even further. One possible note of caution has been posed by a recent survey looking at the last 145 years of data for investable assets – the 'Rate of Return on Everything 1870-2015' looked at bonds, bills, equities and housing over this period and whilst there were a number of inconclusive results it suggests that today's ultra-low interest rate world only looks bizarre compared with the post WWII years of the 20th century; before that rates were often lower for longer. Perhaps the question should be why were rates so high in the late 20th century? The spread between risky and safe assets has been surprisingly volatile over the 145 years and not as a result of the behaviour of risky assets. The caution therefore is that so termed 'safe assets' can periodically display unexpectedly large swings because of war or a financial shock.

Whilst absolute levels of equity valuation look expensive in a historic context, this does need to be viewed in today's interest rate environment. As long as monetary policy globally remains accommodative and the economic recovery continues, a significant setback to equity markets in the short term seems unlikely.

This year has seen a huge divergence between growth and value and as a result valuation levels on many growth parts of the market seem stretched, but despite this, mean reversion investing will remain challenging as disruptive forces and technological change continue at an unprecedented pace, meaning some traditional business franchises will never see a profit recovery.

Markets this year have, to a degree, latched on to the prospect of an extended economic cycle and certainly to one which is more synchronised than US centric. As a result investors should continue to see a positive backdrop to equity markets over the early part of 2018 at least, but at today's valuation levels it would make sense to hold some funds which offer the option of positive returns in a less favourable environment.

Ken Rayner & Graham O'Neill, RSMR
January 2018