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General Economic Overview – Quarter 3 2017

The summer months passed without any major events for markets, with perhaps one of the stand out features being the strength of the euro versus the US dollar. The long bull market which started in 2009 following the financial crisis has continued – one of the remarkable things about this economic recovery is the lack of inflationary pressure both in goods and in wages which has meant that markets have remained quite sanguine despite some souring of political relations between North Korea and the rest of the world. Economic growth has continued to move ahead at a moderate pace, led by the US but increasingly supported by other regions. GDP growth has been below par relative to previous recovery phases but continues to benefit from the growth in consumer demand which has been resilient, despite political uncertainty and little wage inflation. The only worrying factor is that much of this has been based on consumer credit growth which in the UK grew by 10% in the year to April 2017, the fastest annual growth rate since 2005. A specific concern is the new car market which is heavily supported by personal contract purchases (80% of new car sales) and is responsible for half of the growth in consumer credit this year.

The earnings season for many companies has proved positive and ahead of expectations, particularly in the US which has been led by the technology sector. Earnings however remain some way below their previous peak – even in the US where the recovery has been more pronounced, they have only reached their long-term growth rates. This leaves room for the upswing to continue given that there is a slow but steady underlying economic growth rate. The beneficiaries for the moment seem to be the equity markets which have a closer link to earnings growth than bonds, which are expensive relative to history. Equities also have the advantage of offering a decent yield, currently around 2.5% which is nearly double that of government bonds. Different countries are at different stages of recovery so there still seems to be value to be found by investors.

Inflation has started to creep up in the UK meaning there are negative real rates of return for cash savers. Central bank action has been tempered so far by the stubborn nature of wage rises which have not yet reacted to inflationary pressures, but there is some indication that restraint in UK public sector pay is being relaxed following a long period of austerity which may lead to more pressure to raise rates. The reaction to a tightening of monetary policy across the globe is somewhat unknown but it is likely that this will be led by the US as the Fed begins to shrink its balance sheet – this is unlikely to happen quickly but it is now further up the agenda for many central banks in Western markets.

The issue for most asset allocators and fund selectors at the moment is how to balance portfolios with enough participation in the upside whilst protecting on the downside, when a potential correction may well be focused on bond markets, the traditional safe haven area. Most investors are bearish on government and investment grade bonds at current rates and spreads because they have been so low for so long. This area offers little upside even if rates and inflation remain subdued, but should both rise then bonds could suffer capital depreciation. The solution is not easily attained, absolute return options are now widely used for diversification purposes and a number of managers have become defensive as the year has progressed with cash often the preferred option. We prefer to maintain a longer-term perspective believing that any correction (outside of a black swan event) is unlikely to be significant in this current economic environment.

Equity Markets Overview

The market appreciation in the quarter has continued to benefit from investors' ability to ignore any bad news on a macro basis but be more discerning on a stock by stock basis. Many investors believe this is good sign for active managers given the recent investor preference for passive investments, but more broadly we can see both over the quarter and year-to-date there have been some very strong performances from equity markets, particularly in the Far East and in Europe. The UK market has also seen positive returns but the threat of Brexit and the unexpected strength in sterling has weakened investors' confidence in the markets' ability to overcome these factors. The trend in markets has been to support focused areas and companies – for example the US has been led by the technology sector whilst the energy sector has performed poorly and in Japan and the UK, currency weakness has supported the global exporting companies. Another clear trend has been the general support for growth stocks and the gap between the world growth and value indices has widened again in 2017 after the value rally in late 2016. There are a number of theories as to why this is the case, but we tend to believe that it is the more defensive nature of investors, who still want to be exposed to equities in this period of continued momentum, but recognise the length of the bull market and the fragility of growth levels. This leads them to pick more predictable less cyclical stocks. We would anticipate that this situation should normalise but it could persist for some time yet.

UK

For much of the year the headlines regarding the UK economy have been dominated by the current and likely effect of leaving the European Union. The robust levels of growth we have seen since the EU vote have been driven by the weakness in sterling which has helped exporters, and a further easing of monetary policy which has boosted consumer confidence. That said, household consumption has been financed by credit with the household savings ratio at its lowest level since 1960, and the continued global growth which has helped to support the UK economy may not relied upon in the future. The inflation figure is therefore worrying many investors as it moving towards 3%, meaning that real household income has turned sharply negative over 2017, particularly if we recognise that at the same time wage rises year-on-year are at just 1.8%. The rate of retail spending has been reducing with GDP figures this year indicating a much lower growth rate of around 1.2%, well below forecasts at the beginning of the year of 1.7%.

Whilst recognising these issues, many investors have still benefitted from holding equities this year and in the third quarter the main market benchmarks have all been up around 2%, and over 6% year to date. This has been led by the larger more internationally diverse companies with more predictable dividend streams which has resulted in a growth bias in the UK market year to date.

Not all the news is negative however as data is still supportive of continued growth of the economy with unemployment less than 5% and UK PMI data still positive after the election blip.

US

The US market has continued to lead global stock markets upwards in 2017, with all-time market highs which have caused some valuation concerns amongst investors. In dollar terms the market has seen reasonable gains this quarter but for the sterling investor, gains have been limited as the pound has strengthened this year. The forward price to earnings ratio for the S&P 500 is more than 18 times, which is well above other global markets such as Europe and several emerging market nations. This has been led in the main by the technology sector, particularly the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) and has created a split market with some concerns about these stocks being in a bubble.

A further level of uncertainty has been cast by the current level of volatility which according to the Vix index has now reached all-time lows, despite the issues over North Korea – political complications have to be added to the mix and it would be impossible to cover the US without considering the actions of the president which have been seen more on social media than in actual policy making in Congress.

The Trump reflation trade which led markets following his election has fallen flat with no real progress on tax cuts and infrastructure spending and whilst policy stagnation has been tolerated by markets so far, it remains to be seen how long this will last. It is likely that the Fed will continue to raise rates given the positive economic conditions and low levels of unemployment but they will remain sensitive to inflation numbers, in particular wage inflation which has remained stubbornly low. At a company level the earnings season has been positive with many exceeding expectations which has helped to support current valuations. The US is seen as being further into the economic cycle than other countries but this is an unusually elongated period which has investors looking to other markets for value.

Europe

Europe has been one of the stronger performing markets this year thanks to an improvement in both economic conditions and in sentiment among companies and investors. For sterling investors there has been the additional bonus of a stronger euro which has added to returns. Generically Europe is benefitting from the continued loose monetary policy employed by the ECB, but the likelihood is that this will be gradually reduced if the recent policy statements from Jackson Hole are to be believed. The central bank still has a tightrope to walk because Europe is not yet operating at the same speed, with Germany operating a much tighter labour market than the rest of Europe – Turkey, Greece and to a certain extent Spain are all delivering much weaker data. Any tapering from the ECB will be viewed with caution by markets but as long as fundamental company data continues to improve then investors will continue to see this as an area of value.

Inflation figures are weaker in Europe than the UK and the US, and overall employment numbers do not suggest more than a weak recovery so markets are likely to be more sensitive to any uncertainty or weak economic data. The strength of the euro has probably been a negative this year relative to the US and emerging markets, but if economic and PMI data continues to offer encouraging signs then investors will support European equity markets.

Asia

Asian markets have been the beneficiaries of a stable economic regime over the last ten months, particularly the reaction of the US dollar which has been weaker than expected given the lack of fiscal expansion in the US. The Chinese market has risen substantially over 2017 year-to-date, and the majority of the upturn, as in the US, has been driven by the technology stocks and those whose prospects are associated with online growth. For example, not owning names such as Samsung, Alibaba, AIA, and TSMC would have caused a weak relative return for investors.

The economy in China has rebounded and macro risks in China have reduced. Technology and internet stocks have had very positive earnings revisions and as a result of this China, or to be more specific MSCI

China, has been the top performer in the region in 2017. A strong property market in China, especially in the smaller Tier 2 and Tier 3 cities has resulted in low quality property stocks rallying hard.
Laggard sectors have included healthcare, telecom services, utilities and consumer staples in the main defensive sectors, with strong performances from IT, materials, financials and consumer discretionary.

Asian markets have always been a significant beneficiary of US currency weakness and this year has been no exception. Growth prospects have therefore improved in Asia with upgrades to GDP forecasts across the region. As the US currency has weakened capital flows have come back, so current accounts across the region have improved, as have FX reserves compared to external debt. The turn in the US currency has also been beneficial to China, where there has been a focus on new economy names – many traditional consumer names have found life more difficult, even though disposable income continues to grow strongly, partly due to internet or online competition and a lot of multi-national consumer names have come into the market increasing competition. On the negative side, regional geopolitics between the North and South Korea, China and the US has impacted on sentiment, with the ban on group travel or package holidays to South Korea by the Chinese hitting tourism and certain consumer sectors. In Indonesia the economy and consumer spending have been surprisingly weak impacting on domestic orientated names in that market.

Japan

The economic recovery has continued in Japan with Premier Abe now seeking a new mandate from the populous. Inflation, although modestly picking up, remains below the central banks 2% target. Whilst the jobs market has tightened significantly this has largely been in lower paid service sector jobs, and is a reason why wage growth in the country remains subdued. The recent Tankan survey painted a positive picture of company prospects.

The yen has proven to be the linchpin to the expansion of the Japanese economy in recent years and it is this which is likely to continue to boost the market and exporting companies in particular. Sterling has once again started to strengthen against the yen and this has begun to redress some of the weakness for sterling investors in Japan this year. Many active managers have benefitted from the dispersion in the performance of stocks in the main index, comfortably outperforming over the quarter and year to date.

Japanese corporate earnings have been robust and the recent data supports the expansion of profits growth into the third and fourth quarters. The rise in the Topix in the second half of the year has been supported by reduced political uncertainty around the rest of the globe and a weakening yen led by the larger multinational companies, who are the first line beneficiaries. If the yen continues to weaken then Japan may well be a sensible place for investment over the next twelve months on a valuation basis.

Emerging Markets

The emerging world has been a bright spot this year with the rebound in the Chinese economy helping companies throughout the region and also commodity exporters across the world. For example, Brazil, which has been through a recessionary period, has recently seen upgrades to economic forecasts for 2018 and 2019 with the country expected to return to positive growth.

For corporates in China, and in fact Asia in general, the halving of the nominal Chinese GDP growth rate from 15% to 7-8%, which is in effect a company's top line, made operating conditions difficult. Nominal

GDP in China has since picked up and this is a significant factor behind the increase in earnings expectations for the region where, in marked contrast to each of the last five years analyst's expectations, from January have been upgraded. This year EM should see profits growth in the region of 20% and as long as the global economic upswing continues, a further rise of around 10% is forecast for 2018. Positive earnings expectations globally are a factor behind the continued bull run in equities despite in some cases extended valuation levels. India will benefit over the longer term from domestic reforms including the Goods and Sales Tax, even though short-term growth for some businesses has been impacted because of the lingering effects of demonetisation. In Indonesia the economy has been surprisingly weak even though interest rates have been cut with consumption poor. At current valuations EM stocks are still attractive to investors as they have an average forward price to earnings ratio of 12.6 times and are trading at a marked discount to their developed market counterparts. The index has also changed over the last three years, with investors not as exposed to the manufacturing sector, as IT and banks have risen to prominence with IT representing 27% of the index. There is a note of caution here however as the top five technology stocks represent 16% of the index.

Longer term, both China and India will both be key to global growth, yet both are still a small percentage of the MSCI Global Index. By many forecasts China and India will account for 40% of the global growth in GDP to 2030. These two countries already account for one third of the world's population and their growth dynamic means that capital will both be needed and thrown off. Both countries are likely to be chief drivers of global growth over the next decade.

Fixed Interest

The overall view on this sector has been negative for some time with many managers calling time on the so-called bond bull market. Rising rates in the US have generally lifted expectations across the globe for yields to rise and recent statements by the Bank of England and the European Central Bank have reinforced this sentiment. The current levels of yield available on government bonds have left many investors with little choice but to seek higher risk investments to satisfy income requirements. So far, this has not reduced demand as the bond-buying programmes of many central banks and pension funds have been maintained along with loose monetary policy. This regime may well be changing as statements from the US, Europe and the UK central banks have suggested tightening of policy in the near future. The question for many investors is how far this tightening cycle can go in the current low-growth environment.

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. This means capital losses for bond holdings will be lower than anticipated from these current levels. That said, most investment managers are avoiding government debt and investing selectively in credit. Spreads have tightened in the last few months with little opportunity to make gains for investment grade bond holders. High yield has been well supported but even here the risk premium for holding such assets offers less reward. 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 continues to provide diversification for an investor portfolio, at a time when many asset classes are increasingly correlated. It would be extremely risky to move to a portfolio holding just equities, as unexpected events, could happen and in an era of heightened geopolitical tensions, exogenous shocks are always possible. Bond investors have some difficult decisions to make in the coming months, in particular related to which assets to hold for balancing yield requirements with safety for their portfolios. Fixed interest holdings should be maintained in a diversified and balanced portfolio with strategic bond funds continuing to offer investors a spread of fixed interest assets with the ability to react quickly to any changes in macroeconomic conditions. We believe that this will be where the skills of the managers will come to the fore as we transition to a higher interest rate regime.

Property

The physical property market remains relatively stable, despite the continued uncertainty surrounding Brexit. Values did fall following the referendum, with city offices the worst affected. 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.

The retail sector has seen the weakest growth in both capital and rental values – up by 0.9% and 0.2% respectively. Despite this, the total return from the sector was 3.9% and reflects the higher yields that can be obtained. Generally, most businesses are not cutting back on their requirements for retail space. Capital value growth has been strongest for industrials where valuations are fairly well underpinned due to the lack of supply of quality assets. Moreover, there is ongoing demand from retailers for smaller warehouses close to towns, as online shoppers demand tighter delivery windows, while larger spaces are still required for regional and national distribution. Student accommodation proved resilient in the last downturn and investment in this sector provides exposure to a market which is structurally undersupplied, as well as adding to the overall yield.

As an asset class, the fundamentals for commercial property have not changed and the potential continues for valuations to be impacted for those properties, sectors and regions that have experienced the greatest price rises in recent years. The relative weakness of Sterling versus overseas currencies has countered this to some extent as property becomes more attractive to overseas buyers. For the remainder of 2017 returns are still expected to be reasonable but with absolute returns more muted than in recent years. The primary driver of returns will be income with capital growth limited (in some cases negative) and rental growth will become a more dominant factor for performance.

In a low interest rate environment, the asset class continues to be a solid option for income-seeking investors as well as for diversification purposes in portfolios but the liquidity issues experienced in 2016 still provide cause for concern. The secondary market versus primary property yield gap remains attractive but the selection of the individual property will continue to be important.

Global real estate securities may still offer the most potential but equally a greater risk. Yields continue to be reasonable in most regions although growth prospects are weakest in the commercial sector.

Summary

The position for investors today is as intriguing as ever with global stock markets close to all-time highs after a long period of improving valuations. Fixed interest assets are under pressure from a tightening of monetary policy and a reduction in bond buying programmes although the likelihood of rates rising to the levels seen in previous cycles is limited.

There is a growing confidence that global growth can be maintained at current levels as economies continue to recover from the financial crisis some nine years ago. Markets can continue to benefit from the synchronised global recovery for a while yet, especially in an environment where monetary policy overall looks likely to remain accommodative. The end of dollar dominance has proved supportive to emerging markets, and particularly Asia, which is likely to provide the engine to global growth over the next decade.

We are not yet seeing a threat from inflationary pressures, other than in selected economies, and growth has been at subdued levels which is expected to continue. Only the US has really moved into an expansionary phase. At the same time investment managers are broadly taking a more defensive stance in portfolios in the belief that a correction of some kind is perhaps overdue. No-one knows what the catalyst for this might be as even the recent political tensions with North Korea have not really dented investor sentiment. There is always the unexpected event which cannot be predicted but from what we can see there seems little threat to the current economic pattern we are in. Being more defensive is perhaps a natural reaction to an extended, if muted, economic cycle but the conundrum for investors is how to deliver the safety they are looking for whilst participating in the current stock market growth.

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