Market Comment

Overview

The second half of 2017 was another good one for investors who were willing to accept a modicum of risk although, once again, there was little sense of euphoria, even as many equity markets posted new all-time highs. Headlines were dominated by geopolitical events, but consumers and companies around the world did their best to ignore the news, leading to expectations of the highest levels of global economic growth since 2010 and strong corporate earnings.

This outcome might seem all the more surprising given that the period began with increasing tension on the Korean Peninsula and an apparently real threat of nuclear conflict; however, it quickly became clear that neither the US nor North Korea would benefit from initiating hostilities and thus we have been left with an uneasy but stable stand-off, which could well be a situation with which we have to become used to living with.

Global equities delivered a total return of almost 11% over the last six months when measured in US dollars. Sterling-based investors saw those returns cut to 6.6% owing to a combination of a weaker dollar and a recovering pound. That might look disappointing but should be viewed in the context of the enormous windfall that was delivered in 2016 owing to the pound's big fall following the Brexit referendum. Our currency, which by many measures was deemed to offer good value at its lows, benefitted from the progress of Brexit talks which lowered the risk of a potentially disruptive "no deal" outcome. Indeed, the direction of travel appears to be towards a "softer" final outcome, a view that was bolstered by several Conservative MPs voting against the government to amend the EU Withdrawal Bill.

Bonds continued to provide minimal returns which should come as no great surprise given the low starting yields and the strong economic trends. Indeed, if anything, they held up well in the face of pressure for tighter monetary policy in several regions. The US Federal Reserve raised interest rates in December for the fifth time in the current cycle and also started to reduce the size of its balance sheet. The Bank of England raised the base rate for the first time in more than a decade, although it remains at a historically very low 0.5%. These depressed risk-free yields continue to put pressure on investors to seek out more risky investments in the quest for acceptable returns.

The star performer and headline-grabber last year was Bitcoin (along with many of its cryptocurrency peers). We set out our stall a long time ago on such instruments and continue to view them as not being an investable asset class, although we acknowledge that the blockchain technology that supports them is both valid and, potentially, valuable. In our opinion they do not fulfil the criteria of *bona fide* currencies and their price volatility would be most unwelcome in portfolios. We prefer to leave trading in them to speculators.

Key Influences

Two of our main investment themes of recent years have focused on the effects of the rise of populism and the unfolding shift in global monetary policy, and they both remain on our radar. However, the fear factor associated with both themes has diminished over the last six months, allowing risk assets to continue their upward path.

On the political front, it would be premature to declare that the populist tide has turned but it certainly has not delivered the destructive force that was feared. Last year voters in the Netherlands, France and Germany resoundingly rejected far right parties in the final rounds of voting, although it must be recognised that France's Front National and Germany's Alternative für Deutschland did make serious gains in the polls. Indeed, in Germany, this meant that Angela Merkel's Christian Democrats were in no position to form a government and, at the time of writing, coalition negotiations remain inconclusive. The next hurdle to overcome is an Italian election in March where the outcome is currently uncertain. Still, we believe there is enough underlying economic momentum in Europe for the Continent to continue to recover in spite of its politicians. This is very much what has happened in the United States, where Donald Trump's inability to push through much in the way of legislative change until very late in the year failed to hinder the economy.

In the UK, all policy is overshadowed by Brexit negotiations. There seems little doubt that investment in the UK has suffered from the uncertainty and it is hard to see that situation reversing dramatically until the full terms of Brexit are decided. But all is not lost. The weaker pound, despite its recent rally, means that UK assets and products look cheap to overseas buyers, who themselves are operating in a brighter economic environment. It is always easier to weather a period of domestic stress when external conditions are more positive.

Monetary policy presents a greater challenge. The US, UK and Canada, amongst major developed economies, have already raised the local base rate of interest, with the US on track to deliver another three quarter-point rises in 2018, and possibly the same in 2019. That might appear alarming but would potentially only take the Fed Funds rate back to “normal”, offering investors a safe positive real return. We continue to believe that central banks will continue to fine tune interest rates depending on the economic situation. There is no set path which leads into a brick wall. Future decisions will depend greatly on the behaviour of inflation, which has so far been notable by its absence. Eminent economists are unable to reach a consensus on the outlook. Crudely, there are two major camps: the “inflationists”, who believe that it is only a matter of time before tight labour markets lead to a traditional wage/price spiral; and the “deflationists”, who believe that technological and demographic trends will continue to dampen inflationary pressures. We have no strong opinion either way, but do believe that the greater short term threat to markets would be provided by a sharp upward move in wages and/or consumer prices leading to a negative repricing of bonds and other asset classes that take their cue from bond yields. We will monitor the data very closely.

The other big monetary threat comes from the reduction and ultimate reversal of quantitative easing. The Federal Reserve is already shrinking its balance sheet, and the European Central Bank will halve its monthly purchases from €60bn to €30bn in January 2018, potentially reducing that to zero later in the year. Even the Bank of Japan, with its apparently bottomless well of liquidity, has been reducing its purchases of bonds as yields have stabilised. The central banks of the UK and Switzerland are currently on hold. It is widely projected that the aggregate size of these five central banks’ balance sheets will begin to shrink around the turn of 2019. Why is that important? While it is impossible to calculate the full impact, it is beyond question that financial assets have been buoyed by central bank liquidity since 2009. If that liquidity provision is not increased, or even reversed, then it is not unreasonable to expect financial assets to struggle to make progress. That does not mean a crisis is imminent, or even a bear market, which would probably require a recession to unfold in at least one of the major economies, but it certainly presents a meaningful looming risk for investors.

Markets – UK

Despite ending the year at an all-time high, the FTSE 100 Index was something of a laggard amongst major international bourses, at least when measured in local currencies. Much of this was down to the recovery of the pound – itself partially a function of the weaker dollar – owing to the high overseas earnings content. Brexit negotiations continue to dominate the headlines and progress in this area has been a key factor in supporting the pound. Mrs May’s government continues to cling on to power, if only by its fingernails, but this at least blocks the entrance to Downing Street for Labour’s Jeremy Corbyn, a figure who is judged to be hostile to investors’ interests. The underlying economy is putting in a mixed performance. Domestic demand, tempered by weak real wage growth, is sluggish, but there are signs that the pound’s 2016 devaluation, along with growing global demand, is beginning to boost exports.

US

Nothing currently seems capable of supressing the animal spirits of investors in the US market, with the S&P 500 Index making no fewer than seventy new all-time highs during 2017. Furthermore its progress was the smoothest in history, with every month of the year producing a positive total return for the first time since records began. The economy has good momentum, with growth topping 3% in the second and third quarters, despite President Trump’s interventions. The appointment of Jay Powell as the next Chair of the Federal Reserve promises little change to the central bank’s policy of gentle incremental policy tightening.

Europe

Europe is finally throwing off the shackles of the financial and euro zone crises and growth is accelerating. Banks are much better capitalised (although the job is not complete), unemployment continues to fall and election banana skins have been avoided, even if Germany has yet to form a new coalition government. The region is generally viewed as being around four years behind the US in terms of its recovery, so it seems far too early to be taking profits. March's Italian election is the main cloud on the horizon, but even here the main anti-establishment parties appear to have become far less hostile to the EU and the euro.

Japan

Growth is picking up, albeit relatively slowly, but there is a feeling that the rot has stopped in Japan. Prime Minister Abe strengthened his position in a snap election in November, and he, alongside central bank governor Kuroda, remains committed to reflationary policies. The spring wage round will provide some measure of the progress they have achieved. Japanese companies, in aggregate, still sport high cash balances and have the potential to increase returns to shareholders, with improving corporate governance adding more support. Demographics, in the shape of an ageing, shrinking population, remains the biggest domestic challenge to overcome.

Emerging Markets

Emerging Markets led the performance tables in 2017, bolstered by a recovery in commodity prices and global trade as well as a weaker dollar (which tends to underpin fund flows as well dampen the value of dollar-denominated liabilities). China remains the key driver of both growth and sentiment and has once again defied the doom-mongers. Although the country has high levels of debt, it owes little to the rest of the world, so is at limited risk of an exodus of funds. The government is acutely aware of imbalances within the economy and is taking measures to maintain some sort of equilibrium. This might end up taking some gloss off short-term growth but should support more sustainable expansion in the longer term. China is also now relying much less on being the world's source of cheap labour, and continues to add more and more value to its output, creating greater investment opportunities within the country.

Fixed Income

As alluded to in the Key Influences section, there is a battle royal being fought in the bond market between the inflation and deflation camps. There is no clear winner emerging. The US 10 Year Treasury yield (2.4%) is exactly where it was a year ago; UK Gilt yields (1.2%) are a touch lower; German Bund yields (0.42%) are marginally higher – deservedly so given the strength in the economy and the ECB's less loose monetary stance; for comparison, Inflation expectations did rise early in 2017, spurred on by the one year anniversary of the trough in commodity prices, but have since remained subdued.

Inflation expectations are not the only influence on bond yields. Central bank purchases in Europe and Japan continue to drain the supply of sovereign issuance and there is continued demand from, for example, pension funds who are matching long term liabilities. This final factor seems unlikely to abate soon, potentially leaving bond yields lower than they might otherwise be based upon "fundamentals".

The risk/reward ratio for sovereign bonds still looks unattractive, given that a small shift upwards in yields can wipe out a year's income very quickly. They are held mainly to insure against unexpected economic or geopolitical shocks. The higher yields on emerging market sovereign bonds and high yield credit offer a modicum of protection against falling capital values.

Outlook

The upward grind of risk asset prices has been relentless and yet rarely trusted. There is certainly not the sort of euphoria associated with market peaks. Investors have consistently found things to worry about – Trump, North Korea, various elections – but none of them have derailed the economic recovery and, ultimately, it is the profits growth of companies that drives returns. The good news is that the momentum carried forward into 2018 is strong and it is hard to see a major recession evolving without a helping hand. This could be a geopolitical event, but these, by their nature, are hard to predict. A more likely culprit would be a heavy handed central bank, but, given past performance (which, of course, is not necessarily a guide to the future!), we maintain the opinion that central bankers are more worried by the threat of too little growth than too much.

Less optimistically, we are acutely aware that all financial assets have extended their gains with unprecedentedly low levels of volatility, and also for longer-than-average without a material (say 10%) setback. The economist Hyman Minsky (1919-96) observed that longer periods of calm conditions such as we have experienced tend to lead to higher levels of risk-taking which means that any subsequent reversal will be more damaging. We would not be at all surprised to see a meaningful correction some time in 2018, although whether it evolved into a fully blown “Minsky Moment” will depend on the circumstances. We are currently minded to monitor and manage the level of exposure being taken at both an asset class and stock level, rather than unduly move to a more defensive position. This would have been the incorrect stance over 2017 and whilst markets have momentum we are staying with them but, like everyone else, we are trying to spot the catalyst for a pull back.