Market Commentary

February 2018

CAPITAL TOWER

The Right Advice At The Right Time

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These rivers run too deep
With schemes of men for days that lay ahead
They sell their souls so cheap
They breed mistrust and fill my heart with dread

When did the boy become a man
And lose his life to learn
So much confusion to this plan
These times are not changing

Show me the love to keep us together
Open up your hearts don't turn me away
Comfort me through this stormy weather
From where I stand
I see a broken land

This boy has learned to fail
In times like these to cry seems so absurd
His own life's crisis pales
In the shadow of this truly dying world

These are the games we played at school
Our hands raised in despair
With no exception to the rule
These times are not changing

Show me the love to keep us together
Where is the love to keep us together

The Adventures – 'Broken Land'

> "Suspicion is a heavy armour and with its weight it impedes more than it protects."
>
> ***Robert Burns***

January has seen much evidence that the UK is not a Broken Land – helped by the Office of National Statistics declaring that a misunderstanding of how to measure the telecoms sector means *UK GDP growth may have been much greater, and inflation much lower, than the official data recorded*. Because those companies produced data for their customers, which is hard to calculate, the ONS thought the telecoms sector was much less productive than it actually was.

This means UK consumer price inflation (CPI) was much less, and may have been negative, during the years 2010 to 2015, while productivity was greater, and the total of goods and services produced was more, meaning GDP growth during those years was higher than the official statistics recorded. Never mind, eh? It's not like these figures help government determine policy or impact on stock market levels.

Meanwhile, there don't seem to be as many Broken Lands around the globe either.

Bull markets prevail everywhere, and we have now seen the longest period without a 5% drop in the S&P 500 since (daily) records began in 1928. The 399 days without one has boldly gone beyond the 394 days of the late 1990s and the 384 days of the mid-1960s. Since Trump's election victory in November 2016, the S&P 500's biggest fall has been 2.8%, and 83 of the 301 (27%) trading days have seen record closing highs. European equity markets haven't had a fall of 10% for more than 400 days. Yet on average, if the past has any predictive powers, one such fall should take place every 166 days. You could argue that all this is perfectly good news. After all, the IMF has raised its forecast for the world's economic growth in both 2018 and 2019 to 3.9%. Of 1,300 CEOs polled in Davos, 57% (more than double last year's number) expect global growth to improve this year. Corporate earnings are going up.

On the other hand, a Swiss company called Arzyta recently issued a warning. Arzyta generates 47% of its revenues in North America, producing rolls, sweet baked goods and, among other things, the buns for McDonalds. Driven largely by problems in the US where "double digit inflation in distribution costs and higher than expected labour costs in a continually tightening US labour market" are blighting the business's income, the company announced a drastic revision of its likely profits.

And yet Trump's lower taxes could add a further 0.8% to the GDP of an economy that is already running. US unemployment is down to 4.1% – lower than it was in 2007 – and the *cognoscenti* see this falling to 3.5% over the coming year. It was last that low in the 1960s – when inflation was 6%. Meanwhile, at almost $70/barrel, oil (or Brent, at least) has seen a remarkable rebound of 147% from its low of $27.88 (on 20 January 2016.) These matters have to be inflationary.

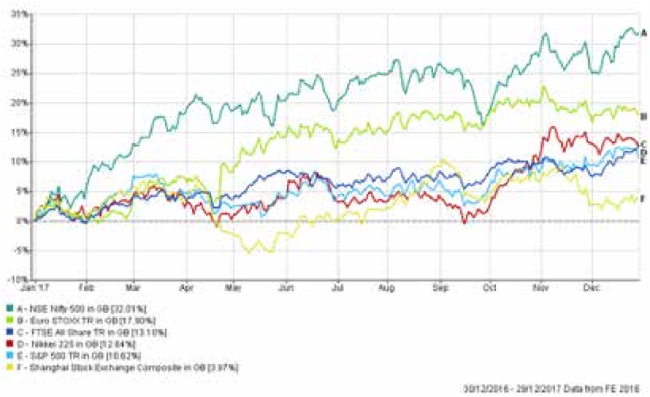
Its other impacts aside, inflation's effect on the bond market is always considerable. An extreme example would be a 2065 index-linked gilt currently yielding -1.543% and priced at £218.64. If that yield moves to -0.543%, the price falls to £136.53 – a drop of some 40%. An exaggerated version, but certainly the bond market should be approached with caution. How already-over-indebted governments, let alone over-extended pension funds, would cope with anything like such a move is a matter of conjecture – and concern. And so investors flock to stocks.

"In economics, the majority is always wrong."

John Kenneth Galbraith

Spot the difference!

The two graphs show the performance of various stock markets through 2017. These show the same stock markets, yet in some cases there is a significant difference between the figures shown – S&P 500 21.10% or 10.62%!



This is all down to currency movements. The first graph plots each stock market in its own currency, the second in sterling. In 2017, we have seen the Dollar reduce in value against the Pound, and we are now just some 5% off the values of some three years ago.

This reminds us that currency can play a huge part in achieving returns. For every currency strengthening, something else must weaken, so it's essential to understand both sides of every coin. Currency behaves like an asset class – it can add or detract value.

Noted US economist Dr Ed Yardeni was interviewed on *CNBC News* last month on a morning that US markets had fallen by 0.4%, and the interviewers were overflowing with excitement over an imminent stock market crash. Their questions featured words like "concerns," "down," "problems," "worries" and "tax reform failures." Yardeni reminded them that this Bull Market had survived 58 "panic attacks" so far, and he saw no reason why the S&P 500 index couldn't hit 3,100 by the end of 2018. "That's another 20% from here," one cried with shocked disappointment written over his face. But Yardeni quietly reeled off a few facts including strong global economic growth to support his views. He's in good company. His belief that there's still scope for this nine-year-old bull market to keep plodding on is shared by many investment companies we speak to.

What goes down must…

The Pound has soared over the past couple of months, creating a stiff headwind for the FTSE 100. However, a bolstered pound should also alleviate the squeeze on UK consumers whose real wages have been falling over that time. A stronger currency is effectively a pay rise for workers, especially those living in a nation that imports most of what it consumes.

Against the euro, which makes up roughly half of the pound's valuation basket, sterling has crept up just a few pence from its post-referendum lows. This is not

"Percentage margins don't matter. What matters always is dollar margins: the actual dollar amount. Companies are valued not on their percentage margins, but on how many dollars they actually make, and a multiple of that."

Jeff Bezos

about better-than-expected UK growth – both the US and Eurozone are forecast to outpace the UK. And the Federal Reserve's increasingly tighter monetary policy outlook compared with the Bank of England's suggests that sterling should actually have *fallen* against the dollar.

Sterling is significantly undervalued on a long-term view, and we should expect it to rise over the course of years (in the erratic fashion that currencies are known for). However, at the moment, it appears that sterling's gain is really just the dollar's loss (GBP vs USD was up 7.5% over the past three months). The greenback tends to underperform in the late stages of business cycles as a greater risk appetite pushes investors to seek better returns in farther flung markets. To do so, investors sell the dollar and buy other currencies, depressing the dollar's value. Of course, when the US Treasury Secretary cheers a weaker currency as a bonus for exporters soon after announcing punitive tariffs on several imports, trends tend to accelerate. Fears of a global trade war and spreading protectionism had slowly died away over Donald Trump's first year in the White House. These worries have now come roaring back…

Summary

Our standard tag line for some while now is that we remain 'cautiously optimistic' on markets. The question is: should we be reviewing this statement, and if so what things might potentially be a cause for concern?

Therefore, as part of this desire to remain open-minded, this week we would like to consider in detail some of the current alternative views on markets. These views are shown below, including our analysis of these views and why we don't believe that they are likely to turn out to be correct.

1. There is too much debt

One view that has been prevalent for a while now is that economic activity worldwide will be held back by the high levels of debt in the system, or that this debt will lead to a contraction in the near future.

Clearly, as we consider the economic environment, the data continues to point strongly to an expansionary environment. The leading indicators from most regions remain strong and point to a continued expansion for some time yet.

While the debt exists, a very significant portion of it is held by the central banks of the issuing nations, and as such, in theory, it has been neutralised. It is safe to assume that the asset and liability that these central bank holdings represent can safely be netted off in this case, as no central bank will be causing its own government to default. So, much of the debt overhang was effectively solved with the start of the QE programmes many years ago. Will this change, as the central banks wind down their QE programmes and ultimately stop refinancing maturing bonds or sell existing holdings? Perhaps, but ultimately it isn't happening now, and certainly no central bank will want to endanger economic expansion simply to reduce the size of its balance sheet.

2. Markets are expensive

Another view is that equity markets are too expensive. This is based on various measures that compare current or near-future levels of profits to market values to create a price-to-earnings measure. The problem with this approach is that it has little or no predictive value; markets were more expensive twelve months ago despite having had a stellar year. Saying that markets will go down because they are valued highly is a risky strategy that hasn't historically proven successful.

"To improve is to change; to be perfect is to change often."
Winston Churchill

3. We will remain in a deflationary environment
A third alternative view is that we remain in a deflationary environment, and therefore bond yields will continue to fall. In reality, the falls in bond yields over the past few years have more been due to falls in real yields, not inflation, perhaps because of central bank intervention leading to a scarcity of government bonds. Can real yields fall back into negative territory sustainably in the future, leading to strong gains for bond investors? Perhaps the former is possible if the economy starts to contract significantly, but, given the already low level of yields, significant gains in capital value are not on the cards. For corporate bond investors, the outlook is arguably worse still. If the economy contracts and real yields fall, then credit spreads will expand and credit losses will grow, likely more than offsetting any yield contraction.

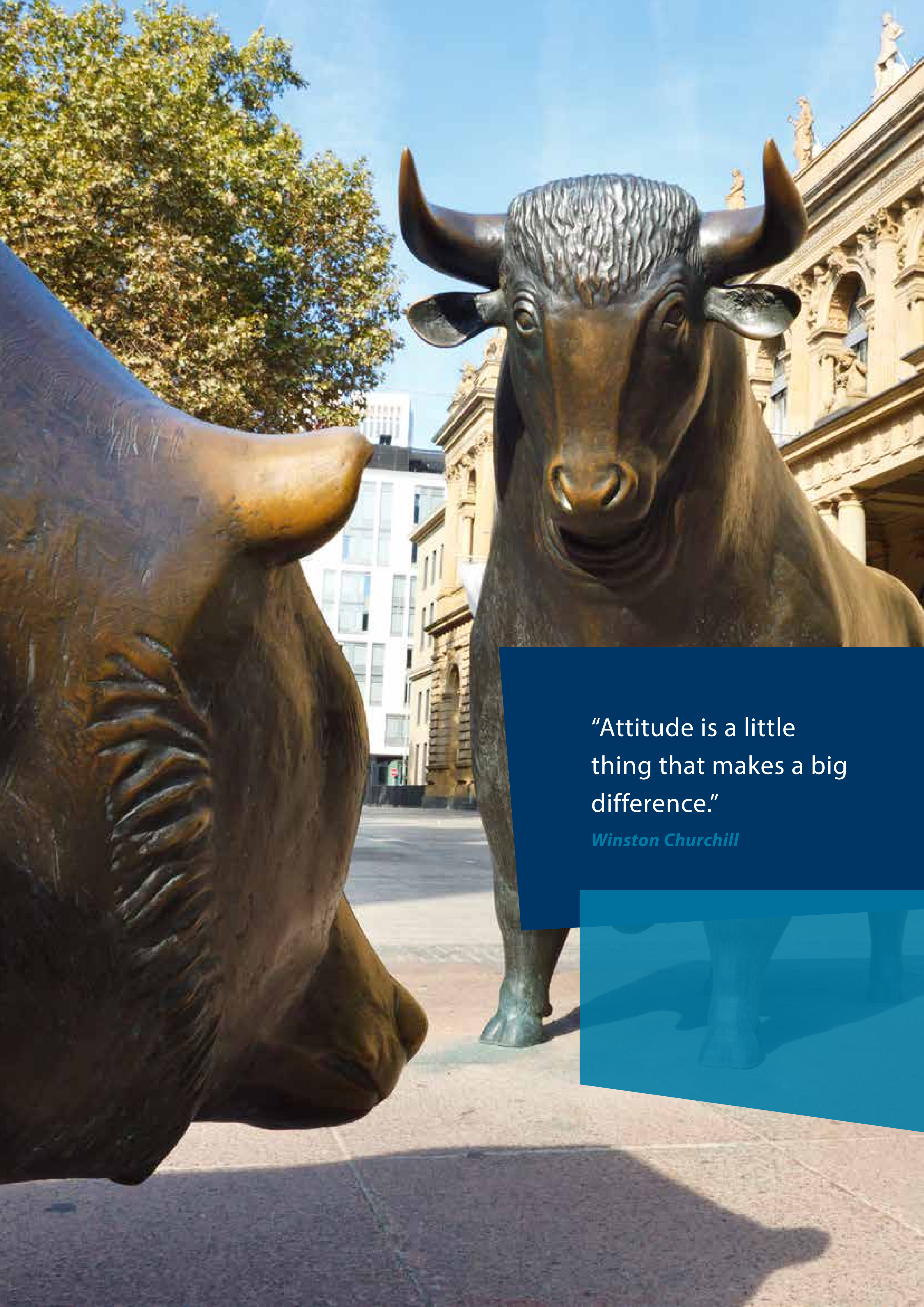
In a more expansionary scenario, which we see as more likely, credit spreads are likely to narrow further, but this is very likely to be offset by rising yields leading to capital losses, partially offsetting the income earned. The reality of the deflationary/disinflationary viewpoint and reality now struggle to co-exist, as inflation has been gradually rising against the background of a growing economy. While this has been positive for markets, it is unlikely to lead to positive returns for credit in the future.

4. Inflation risk
Lastly, a further risk to the current expansion is that labour market tightness leads to inflationary pressures and a monetary policy response that tightens economic conditions and slows growth. In this scenario, rising wages will create higher levels of inflation, which will in turn cause Central Banks (the US Federal Reserve in particular) to raise interest rates more quickly than anticipated.

Here, technology could throw a spanner in the works because it is a disinflationary force: technology goods themselves get cheaper as the underlying rate of innovation accelerates. The transition to new internet-based and automated services is generally accompanied by a downshift in prices (the "Amazon effect"); firms experiencing a technology-induced rise in productivity may price more aggressively; and technology puts downward pressure on wages to the extent that it is a substitute for labour.

Indeed, during the last major period of tech investment and adoption in the late 1990s, growth and productivity rose while inflation remained in check, contributing to the longest economic expansion in post-war history.

In summary, although there are a number of alternative viewpoints, they all appear to be based on assertions about a future which may exist, without being supported by any evidence in the current data. Obviously, should the evidence in the data change in future, we will need to reconsider our views.



> "Attitude is a little thing that makes a big difference."
>
> ***Winston Churchill***

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