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Investment update

Pause for thought

Spring 2017

White House on Fifth Avenue

Brexit and Europe

Markets `priced for perfection'?

Mark Robinson
Director
Chief Investment Officer

Overview

Financial markets have ended the first quarter of 2017 in a slightly more measured fashion, interrupting the largely unbroken period of rather surprising upward momentum that has occurred since both the EU referendum and, more recently, Donald Trump's installation as US President.

Since November, markets have generally been buoyed by the perceived positives from Trump's 'reflation' agenda, involving greater infrastructure spending and fiscal reforms, which have led to more positive expectations on economic activity. The inflationary backdrop has also seen an upward shift, causing US interest rates to rise again and expectations of a move in places like the UK to also alter.

Whilst it is pleasing to report that economic conditions have generally improved over the past few months, markets at last seem to be waking up to the fact that they cannot climb unchecked based on hope and expectation alone. The transition from loose to tighter monetary policy clearly needs very careful handling, for instance, and markets also need to adjust to all manner of other issues, any one of which could potentially throw things off course. Now that the starting gun has officially been fired on Brexit, just how economic activity will be impacted is virtually impossible to predict at this stage, but as we have noted before, financial markets typically dislike uncertainty.

Whilst not wishing for a setback, we feel we are well positioned both to withstand a broader market adjustment and to potentially take advantage of one, depending on what the trigger is and whether the fundamental outlook has improved or not. This may seem paradoxical, but our active approach continues to be guided by sound fundamental investment principles rather than flimsy shorter term hope. Being patient and potentially going against the general market herd feels more right than wrong at this juncture, although we accept things are delicately poised and some further, but perhaps increasingly blinkered, market enthusiasm could continue.

31 March 2017

White House on Fifth Avenue

President Trump's reflationary agenda has been an unexpected tailwind for markets in recent months, but after all the initial showmanship and bluster there are signs that the 'Trump trade' is beginning to fade.

Trump's early morning tweets and protestations of fake news have certainly diminished and are unlikely to be missed by many, but it is his casual pro-growth promises, generally lapped up by markets to date, which are now being placed under increasing scrutiny. Trump seems to be finding out the hard way that the process of getting a White House job done is very different to thumping the desk in a Fifth Avenue tower block. At the end of Trump's first quarter in office, it seems that markets are also beginning to pay a bit more attention to the political, judicial and diplomatic processes needed to successfully implement his policies. Whether the recent tailwinds become headwinds remains to be seen, but there certainly seems to be little room for disappointment in a market which has largely moved forward unchecked.

Going forward, the state of the US economy appears to be quite pivotal in terms of a wider economic and market sentiment. Whilst the economic trend is reasonably encouraging, the number of positive surprises to growth seem to be peaking and look set to ebb now that the monetary policy cycle is on the turn. A lot of weight has been placed on President Trump's reforms, but this poses risks from two angles: either tax and other reforms, plus infrastructure initiatives, will be fully implemented, placing greater pressure on the Federal Reserve to raise US interest rates more aggressively, or certain initiatives will not gain approval or will be delayed (or indeed withdrawn, as we have seen with Trump's healthcare bill). Whilst it can be argued that the successful implementation of Trump's policies could prolong the market's 'risk-on' mood, the greater balance of risks appears to be to the downside rather than the upside, particularly since most of the positives associated with Trump's 'reflation' agenda seem to have been priced in already.

Brexit and Europe

We can probably expect the complex political backdrop in Europe for 2017 to have a greater influence on economic activity and market behaviour over the coming months.

Brexit negotiations, for example, could be taking place at a time of heightened general European political uncertainty, with individual political events in key EU countries such as France, Germany and Italy due to take place this year. Furthermore, financial pressures in Greece, which destabilised confidence in the first half of this decade, could yet resurface and complicate the backdrop. Finding reasonably stable ground for Brexit negotiators among the collective EU27 will be hard enough, but the potential for political change or a rise in populist movements among the member nations could delay or frustrate EU divorce proceedings. So far, the economic damage caused by Brexit uncertainty has been more muted than most originally expected. However, to expect markets to move smoothly through the heavy European political and Brexit workloads will be a big ask.

Markets 'priced for perfection'?

To some extent stockmarkets seem to be priced for perfection.

In the US, for example, the forward Price/Earnings (P/E) ratio on the S&P 500 Index is approaching 18 times, significantly higher than its five or ten-year average, whilst the cyclically adjusted P/E, which views corporate earnings over a much longer period, shows a reading approaching 30 times. This level has been seen only twice previously, once immediately prior to the 1929 Great Depression, and the other when the market ascended to an even headier peak in the late 1990's technology, media and telecom boom. Seeing companies like Snap Inc., which has accumulated losses of $1bn over the past two years, come to the market on an eye-watering valuation of $30bn, equivalent to 75 times its current annual revenue, does make one sit up and think about whether we are entering 'bubble' territory.

Similar anecdotal evidence that we are nearer an economic and market peak than a trough can be found in the ratio of market 'bulls' to market 'bears', which recently approached levels last seen at the market peak in early 2015 and prior to the stockmarket crash in 1987. Meanwhile, a recent Bank of America Merrill Lynch survey of global fund managers showed that the net percentage of respondents who considered equities to be overvalued had reached its highest level since the start of this millennium. Some care, it would seem, needs to be exercised.

Our portfolio positioning

If it is not obvious from our current and previous writings, it still seems prudent to continue to act with a sensible degree of caution and wait for some of the issues that we have flagged up previously to be more fully recognised by markets.

Of course, we would be delighted to learn that our caution had proved unnecessary, but we feel that investors should be prepared for a more meaningful market adjustment. As this is written, so-called safe haven assets like gold seem to be reacting more positively to some increased investor caution. Inflation-linked bonds are also playing an important role as inflationary expectations rise. So, despite having reduced stockmarket exposure, other assets are still earning their keep.

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Contact us

For further information, please visit our website at:
www.bordieruk.com

Bordier & Cie (UK) PLC
23 King Street, St James's, London SW1Y 6QY
T: + 44 (0)20 7667 6600 | F: +44 (0)20 7930 2911
E: enquiries@bordieruk.com

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