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Investment update

The next leg

Summer 2017

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Overview

It has been another rather unpredictable period for financial markets, with a confused cocktail of economic, political and corporate news keeping markets on edge.

The list of event risks and market hazards that we have previously highlighted, and which has caused us to proceed with increasing caution, has not become any longer or shorter. Issues such as impending monetary policy change, stretched market valuations, political issues and escalating levels of government and consumer debt continue to influence our thinking and investment positioning. A few risks appear to have dissipated in recent months whilst others have become more acute and some new ones are emerging. However, despite these issues, it is still encouraging to end the first half of 2017 at higher market levels than when we started.

The second quarter, though, has been harder work than the first. Some modest progress has still been made, although currency movements have had a bigger influence on stock and bond markets, mainly due to political issues and swaying opinion on monetary policy. For much of the past quarter, bouts of volatility have been quickly expunged, but more recently cracks in market sentiment have begun to appear and there is a sense that the risk scales are at last beginning to register some of the problems that hitherto have rather been swept under the carpet.

Even if some of these cracks develop into wider market fractures, do not necessarily expect us immediately to take advantage of them. We have built more caution into portfolios steadily over the past year and resisted the temptation to re-introduce risk whenever there have been small corrections, particularly since the fundamental backdrop has not improved. We intend to be similarly careful when putting more risk back onto the table.

1 July 2017

Risk aware at last

It is good to see stockmarket participants generally becoming a little more discerning about valuation levels and some of the economic, market and political risks that still prevail.

Two areas worth highlighting, and which appear to have swapped places in the league of risks, are the US and Europe. It is interesting to note, for example, that investors' general love affair with the US stockmarket, which has been the dominant force behind global equity market returns for some time, has faded recently - it has actually been the laggard amongst developed markets since the start of April as the expectation surrounding President Trump's reflationary policies has fizzled out.

European markets, however, have picked up the baton as economic momentum, aided by low interest rates and continued quantitative easing, has come through and better-than-expected outcomes in European elections (at least from an economic perspective) have lifted sentiment. So maybe the tide is beginning to turn away from the more expensive areas of the market and back to some of those areas that have been somewhat neglected, which will be no bad thing.

Economic positives

On the positive side of things, and at a headline level, the general economic picture is still reasonably encouraging, but perhaps it should be after several years of exceptionally accommodative stimulus.

That said, headline economic growth in the major developed world economies of around 2% or less is actually nothing really to write home about, in contrast to some of the stronger growth rates in Asia and emerging economies where the need for monetary authority assistance has also been much lower. One could argue that the effectiveness of monetary policy in several economies has now been exhausted, hence the need to turn, for example, to fiscal measures to maintain or stimulate activity. But even this tactic faces issues, as we have seen in the US with delays to tax reforms. Overall, there is evidence that some of the positive economic surprises in leading economies are beginning to dwindle.

Interest rates on the move?

Aside from Brexit, one area that seems to be moving up the UK risk list is the sharp rise in inflation and the impact not only on the consumer but also the decision-making by the Bank of England's Monetary Policy Committee (MPC).

Rather than creating more stimulus and encouraging growth in the economy, the cut in interest rates after the EU referendum appears to have contributed to the downward pressure on the pound which, despite a modest rally recently, has still fallen by around 15% versus the US dollar and 12% versus the euro since immediately before the Brexit vote. This collapse has made foreign goods more expensive and imported inflation to our shores. In June last year, UK consumer price inflation was just 0.5% - now it is around 3%. The MPC had previously indicated that it would look through what it felt would be a temporary pick-up in short-term inflation, with the Bank of England (BoE) governor recently indicating that 'now is not yet the time' to raise interest rates. The MPC may yet be correct in exercising restraint, and having perhaps moved too early to reduce rates post the Brexit vote, its current reluctance to act swiftly now that inflation has gathered speed is somewhat understandable. But with the BoE's chief economist suggesting that a rise in interest rates would now be prudent, the governor also now seems to be changing his tune. In an environment where markets analyse policymakers' every word, it is not surprising that bond, equity and currency markets have become more twitchy to this confused rhetoric as the first half of the year has come to a close. The MPC is therefore likely to respond to counteract this sharp rise in inflation before it becomes baked in.

The risks of getting this wrong, however, are significant. How the MPC's next move impacts bond and equity markets in particular, has now joined the risks facing the US and Europe. The elephant in the room though, is that having virtually exhausted all conventional and unconventional avenues of economic stimulus, it is difficult to see quite what assistance the authorities could give next time when businesses and consumers need it. Therein lies an issue that has probably become a little more acute in recent months, and needs close monitoring.

Head for heights

Several risk assets are still up on the circus high wire. To date the protection afforded to them by easy monetary policy and associated excess liquidity has helped to limit any market wobbles.

But it is probably asking too much of markets to maintain their relative calm now that this safety net is being gradually withdrawn. In our view this is not a time for getting lured into some of the excitement that often precedes economic or market turning points - it is about positioning for a period where markets stop looking through rose-tinted glasses and take more notice of some of the issues created by this extreme period of monetary stimulus, particularly now that it appears to drawing to a close. `Strong and stable' are words that have now disappeared from the vocabulary of the UK's Prime Minister, and they also seem equally inappropriate labels for the broader economic backdrop and prospects for markets in the second half of this year. At the risk of becoming somewhat repetitive, we still feel that exercising caution is warranted.

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