

Weekly Digest

Week ending 3 December 2017

Blame or acclaim the Fed?

Portfolio managers have heard very different assessments of the role played by the Federal Reserve and other central banks in the aftermath of the Global Financial Crisis. Some say the Fed saved the world in 2008/09 by unfreezing capital markets; others think they are responsible for a bubble in asset prices and a rise in wealth inequality, the effects of which are yet to be fully felt but will be extremely painful when they are.

Embarking on Quantitative Easing (QE) was logical in portfolio managers opinion. If you accept that the current model of using interest rates to manage aggregate demand in the economy and hence inflation is reasonable, then, having cut short term interest rates to zero and with time running out, what do you do? You can't reimagine the financial system overnight in order to introduce meaningfully negative short term interest rates without creating a run on commercial banks. Hence the answer: buy longer dated bonds in order to push down longer term interest rates. Not only are borrowing costs and debt servicing costs (think standard variable rate mortgages) lower today, individuals and companies have greater visibility that they will stay low for longer which should help bolster consumption and investment.

The action of buying government debt does push up asset prices, no question. In the first instance, the prices of the bonds actually purchased, because we have a new bidder in the market; but also all other assets, because the discount rate has been reduced, which means all future return streams embedded in assets are worth more discounted to the present. In other words, assets are worth more not just because there are more buyers in the market, but because they are more valuable assets in the context of a world where you can earn less by lending to the government and other high quality borrowers. Therefore, current holders of assets see their net worth go up, an outcome which has been extremely contentious.

Part of the problem is that the benefit has not been evenly distributed. Despite new rules around pension enrolment (at least in the UK), relatively few people believe that they are directly affected by record highs in the stock market and rising

bond prices. Further, second order benefits from the wealth effect have also been muted. We expect to see consumption rise whenever asset prices increase: if your house goes up in value, people tend to borrow against it and spend, thereby increasing aggregate demand. This helps to bolster growth and employment. We haven't seen this to the same extent with QE because the number of people who have financial assets that are disposable – i.e. not held in some kind of long term structure like a pension – is small. And similarly, these people have a low propensity to spend, because, on average, they are already relatively comfortable/sated.

What this means is that QE was logical, but the transmission of this stimulus has been less powerful and slower to work than portfolio managers might have expected. Was there an alternative? It would be foolish to say no – there is always an alternative – but portfolio managers at a loss to think of one. So-called 'helicopter' money debases the currency and hence can be extremely destabilising if not managed carefully. Expansionary fiscal policy runs the same risk in the context of highly indebted governments. Instead, new money was put in the hands of commercial banks, who – despite their tarnished reputations (deservedly so) – are the most skilled lenders in the economy.

Today portfolio managers can only speculate about how things would have been if the Fed and other central banks hadn't intervened. The consensus is that the policy was a success and economies continue to heal. There are currently fewer countries in recession than at any point in the last 30 years according to a Deutsche Bank paper circulated a few weeks ago. Things take time to work themselves out in the aftermath of a crisis, not least of all because consumers have memories and are therefore likely to remain risk averse for a while. While continuing to take the pulse of markets and economies during what remain extraordinary times, current base case scenario is that inflation will come back and interest rates will gradually normalise - the views of which you can currently see reflected in the portfolio positioning.

The Marketplace

- Brent crude finished the week @ 63.70, down 0.2%
- Gold had an overall flat week closing at 1283.6, down -0.4%
- Bitcoin swings over 20% intraday
- Bond yields up sharply
- Tech stocks slide as \$62bn wiped off FANG stocks last week

Market Focus

US

- The Dow Jones ended the week at 24,231.6, up 2.86%, Thursday the 30th saw another all-time high on the index
- The Nasdaq finished the week down -1.1% at 6337.9 on the back of the tech sell off
- The controversial tax reform bill passes through the senate. The backbone of the bill remains the corporate tax rate being slashed from 35% to 20%
- FANG stocks decline on the back of expected tax cuts from the Fed –investors favour bank stocks as they're seen to benefit most
- Michael Flynn, Trump's former security adviser admits lying to the FBI over his communications with Russia in the run up to the presidential election

UK

- The UK and the EU still working on a workable solution to the problem of the Irish border. Early suggestions are that the UK will concede to no regulatory divergence
- GBP the best performing G10 currency in November

- Jean-Claude Juncker and Theresa May to meet today. The role of the ECJ in enforcing citizen's rights seen as a key point and potential red-line in negotiations
- The FTSE was down 1.5% on the week, closing at 73,00
- Facebook to increase its UK workforce by 50%, making it the largest hub outside of the US

Europe

- The Eurostoxx 50 fell -1.5%, closing at 35,27.5
- Unemployment in the Euro-area dropped to 8.8% though inflation misses estimates at 1.5%
- Euronext buys Irish stock exchange looking to consolidate as the largest European trading venue for ETFs
- Euro-area manufacturing PMI rose to 60.1 in November from 58.5 in October –the fastest pace since 2000

Asia

- The Nikkei was up 1.19% at 22,819
- China manufacturing PMI rose to 51.8 from 51.6 beating expectations and non-manufacturing rose to 54.8 from 54.3
- The Hang Seng fell -2.7% finishing the week at 29,074
- China likely to overtake the US as the world's largest importer within 5 years

Richard Stutley (CFA) & James Jones

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Asset Class/Region	Currency	Currency returns			
		Week ending 1 Dec. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	1.6%	-0.2%	19.6%	22.3%
United Kingdom	GBP	-1.4%	-0.4%	6.0%	12.0%
Continental Europe	EUR	-1.0%	-0.9%	11.0%	18.7%
Japan	JPY	0.9%	0.2%	20.6%	23.7%
Asia Pacific (ex Japan)	USD	-2.8%	-0.2%	32.7%	30.7%
Australia	AUD	0.1%	0.3%	10.2%	13.7%
Global	USD	0.5%	-0.4%	20.3%	23.4%
Emerging markets equities					
Emerging Europe	USD	-2.5%	-0.5%	13.9%	24.3%
Emerging Asia	USD	-3.8%	-0.4%	38.4%	36.3%
Emerging Latin America	USD	-3.1%	0.4%	18.9%	25.2%
BRICs	USD	-4.3%	-0.7%	36.8%	36.5%
MENA countries	USD	0.9%	0.0%	-2.5%	0.5%
South Africa	USD	0.1%	-2.0%	22.6%	30.2%
India	USD	-2.2%	-1.0%	31.8%	32.2%
Global emerging markets	USD	-3.3%	-0.4%	32.0%	32.9%
Bonds					
US Treasuries	USD	0.0%	0.4%	2.5%	2.8%
US Treasuries (inflation protected)	USD	0.1%	0.4%	2.7%	2.8%
US Corporate (investment grade)	USD	0.1%	0.4%	5.9%	7.0%
US High Yield	USD	0.1%	0.0%	7.2%	9.2%
UK Gilts	GBP	0.1%	1.0%	1.4%	4.0%
UK Corporate (investment grade)	GBP	0.2%	0.7%	3.9%	6.9%
Euro Government Bonds	EUR	0.6%	0.5%	1.5%	2.6%
Euro Corporate (investment grade)	EUR	0.3%	0.3%	3.0%	3.9%
Euro High Yield	EUR	0.0%	0.0%	6.9%	9.0%
Japanese Government	JPY	-0.1%	0.0%	0.1%	-0.5%
Australian Government	AUD	-0.1%	-0.2%	4.2%	4.4%
Global Government Bonds	USD	-0.2%	0.1%	6.7%	6.4%
Global Bonds	USD	-0.1%	0.1%	7.1%	7.1%
Global Convertible Bonds	USD	-0.7%	-0.4%	10.1%	11.5%
Emerging Market Bonds	USD	0.1%	0.2%	7.8%	10.1%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-0.4%	0.2%	4.4%	10.8%
Australian Property Securities	AUD	1.7%	0.0%	2.0%	10.0%
Asia Property Securities	USD	-1.2%	-0.2%	24.6%	19.7%
Global Property Securities	USD	-0.5%	-0.1%	13.9%	17.9%
Currencies					
Euro	USD	-0.2%	0.1%	13.2%	11.7%
UK Pound Sterling	USD	1.3%	0.0%	9.3%	7.3%
Japanese Yen	USD	-0.4%	0.5%	4.5%	1.9%
Australian Dollar	USD	0.1%	0.7%	5.9%	2.8%
South African Rand	USD	0.8%	-0.6%	-0.6%	2.4%
Swiss Franc	USD	0.5%	1.0%	4.6%	3.7%
Chinese Yuan	USD	0.0%	0.3%	5.5%	4.4%
Commodities & Alternatives					
Commodities	USD	-0.3%	1.1%	2.8%	4.1%
Agricultural Commodities	USD	0.3%	0.6%	-3.1%	-2.2%
Oil	USD	-0.2%	0.3%	12.2%	18.1%
Gold	USD	-0.3%	1.0%	11.4%	9.6%
Hedge funds	USD	-0.1%	0.0%	5.2%	6.1%

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