

Weekly Digest

Week ending **10 September 2017**

The global cycle has further to run

Despite nervousness around North Korean brinksmanship, devastating hurricanes, and the approaching US debt ceiling, global equity markets produced their tenth consecutive positive return last month, the longest run of gains in over thirty years. The MSCI World index has delivered a total return of 15.4% in local currency terms over that period and has risen by over 230% since the lows of March 2009. The US has been the strongest performing market over this period, gaining 337%, making it the third largest US bull market in history. Equity valuation levels are high, including the popular cyclically adjusted Shiller PE measure which has climbed to a level of 30, a multiple of earnings that was only surpassed briefly during 1929 and for several years during the dot com bubble. With statistics like these it is easy to draw a bearish conclusion; that equities are expensive and this bull market is on its last legs. However, our view is that this current cycle is sustainable and still has further to run. Several factors lead us to this conclusion.

To begin with, the global economy is in a synchronised growth phase, the likes of which have not been seen in this current cycle until recently. Most economic indicators - including purchasing manager indices, survey data, consumer confidence and unemployment levels - show healthy economies around most of the world, which has resulted in global GDP growth reaching 3.8%, its fastest pace for seven years. This improvement in fundamentals has produced a strong rebound in business confidence and corporate profits, which has led to a recovery in capital expenditures.

Meanwhile, levels of core inflation around the developed world remain low and below the 2% targets of the major central banks, while market expectations for inflation have dipped over the last couple of months. This is giving central banks the breathing room to continue running very loose monetary policy. Although the Fed and ECB are likely to withdraw a significant amount of liquidity over the next couple of years, they will retain much larger balance sheets than before the crisis and real interest rates will remain low, even in the US where the current rates cycle is expected to peak out at over 2% below the highs of previous cycles. This is understandable given the considerable headwinds to global growth, particularly from demographics, low productivity growth and high debt levels, none of which are likely to reverse anytime soon.

These factors have underpinned growth in corporate profits, which have rebounded strongly from the commodity driven shock

of 2015, and also equity valuation levels. Although valuations have moved higher across most markets they are generally not at extreme levels and should fall as earnings growth comes through. Unless inflation begins to pick up meaningfully - which seems unlikely, but could lead to more aggressive tightening of monetary policy - then it makes sense for equities to sustain higher valuation levels while bond yields remain near their lowest levels in history.

These observations are all well-known and generally are not controversial. However, they are vital to understanding the sustainability of this current cycle. GMO's Jeremy Grantham, one of the world's leading value investors, recently wrote a letter titled 'This Time Seems Very, Very Different'; apart from being recommended reading for those in search of a more detailed and eloquent opinion around this topic, it's notable given he is probably one of the last investors that would be expected to make such an argument! To be clear, the portfolio managers do not think investors should expect global equities to continue to compound returns at 15% per annum, as they have since 2009, but they do expect low positive returns in excess of anything available in bond markets. While the managers have lower equity allocations across the portfolios than eighteen months ago, reflecting the risk/reward trade-off not being as compelling as it was at the start of 2016 after markets had sold off aggressively, they retain meaningful allocations and will look to use any further dips in markets as buying opportunities.

Markets have been exceptionally benign of late but that (probably) won't go on forever. If history is any guide then a setback is overdue - implied volatility is bouncing off all-time lows and this is the third longest period between falls of over 3% for the S&P 500 since World War II. There are various serious risks out there that could trigger a correction, particularly around geopolitics and central bank policy, but there has always been something to worry about throughout history so any such setback should not come as a surprise and would probably be healthy for the longer term. Indeed there were plenty of negative events in the last year that could have reasonably been expected to prompt a correction, but instead markets have continued to climb the wall of worry, much to the surprise of most investors. The managers of the core portfolios have always stressed the difficulty of market timing around particular events or risks, instead encouraging a longer investment horizon, and this recent phase certainly supports that. It is important to stay invested.

The Marketplace

- Oil prices rose 2% on the week with Brent at USD 53.9
- Gold rose 1.9 % to 1347, its third week of gains
- Risk appetite returns as treasuries retreat, stocks advance
- Apple set to launch the iPhone 8 and X models this week
- Hurricane Irma devastates the Caribbean and Florida

Market Focus

US

- Hurricane Irma leaves 1.4M homes without power in Florida. It has a force three times greater than Hurricane Harvey
- The S&P 500 Index was down 0.6% last week at 2,461 with financial stocks notable underperformers
- The Dow Jones index ended the week at 21798, down 0.9%
- Nasdaq was down -1.2% at 5913
- US treasury yields decline towards 2%

UK

- Construction shrank for the fourth month in a row though manufacturing rose 0.5% in July- mainly on the back of 14% increase in vehicle output. A mixed picture for Q3 so far
- UK Equities finished the week down 0.8% with the FTSE 100 closing at 7377

- BoE expected to leave benchmark rate unchanged at 0.25% as CPI accelerated and consumers feel the squeeze
- Parliament to vote on the second reading of repeal bill - Labour whipped to vote against but expected to pass.

Europe

- ECB officials mulling cutting asset purchases to EUR40 -20Bn
- Manufacturing PMIs climbed to 57.4 in August from 56.6 in July
- Euro Stoxx 600 closed the week at 376, down 0.6%
- The Dax increased 1.3% to 12304

Asia

- Nikkei closes +2% on the week at 19545
- The Hang Seng finished the week down 1%
- Yen fell 0.7%, the biggest fall in a month
- North Korea missile test failed to materialise restoring some confidence to markets

Andrew Hardy (CFA) & James Jones

Asset Class/Region	Currency	Currency returns			
		Week ending 8 Sep. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	-0.6%	-0.4%	11.0%	14.5%
United Kingdom	GBP	-0.8%	-0.7%	6.7%	11.8%
Continental Europe	EUR	-0.1%	0.4%	8.4%	13.3%
Japan	JPY	-1.6%	-1.5%	6.2%	21.0%
Asia Pacific (ex Japan)	USD	0.1%	0.4%	27.8%	19.8%
Australia	AUD	-0.6%	-0.3%	3.5%	10.1%
Global	USD	0.0%	0.3%	13.8%	14.8%
Emerging markets equities					
Emerging Europe	USD	0.3%	0.6%	16.8%	23.7%
Emerging Asia	USD	0.1%	0.2%	32.1%	21.5%
Emerging Latin America	USD	1.0%	2.4%	27.8%	20.4%
BRICs	USD	0.3%	0.7%	32.7%	23.9%
MENA countries	USD	0.8%	0.8%	6.3%	14.9%
South Africa	USD	-2.2%	-1.5%	18.1%	11.1%
India	USD	-0.6%	0.3%	30.4%	17.1%
Global Emerging Markets	USD	0.0%	0.4%	28.8%	20.3%
Bonds					
US Treasuries	USD	0.6%	0.4%	3.7%	-0.4%
US Treasuries (inflation protected)	USD	0.9%	0.8%	3.3%	1.0%
US Corporate (investment grade)	USD	0.5%	0.2%	5.6%	2.9%
US High Yield	USD	0.1%	0.2%	6.2%	8.4%
UK Gilts	GBP	0.8%	0.5%	3.2%	-1.6%
UK Corporate (investment grade)	GBP	0.5%	0.3%	4.9%	1.9%
Euro Government Bonds	EUR	0.4%	0.2%	0.3%	-2.5%
Euro Corporate (investment grade)	EUR	0.2%	0.1%	2.1%	0.7%
Euro High Yield	EUR	0.1%	0.2%	5.6%	6.8%
Japanese Government	JPY	0.1%	0.2%	0.4%	-1.0%
Australian Government	AUD	0.5%	0.8%	3.2%	-1.2%
Global Government Bonds	USD	1.4%	1.3%	8.4%	-0.7%
Global Bonds	USD	1.1%	1.0%	8.3%	0.9%
Global Convertible Bonds	USD	0.5%	0.8%	9.5%	6.2%
Emerging Market Bonds	USD	0.8%	0.8%	9.7%	3.5%

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Asset Class/Region	Currency	Currency returns			
		Week ending 8 Sep. 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	0.7%	1.1%	4.1%	-2.0%
Australian Property Securities	AUD	1.2%	1.4%	-4.3%	-7.5%
Asia Property Securities	USD	1.3%	1.0%	23.3%	12.5%
Global Property Securities	USD	1.2%	1.3%	12.9%	4.4%
Currencies					
Euro	USD	1.4%	1.2%	14.3%	6.8%
UK Pound Sterling	USD	1.8%	2.3%	6.7%	-0.8%
Japanese Yen	USD	2.2%	2.1%	8.5%	-5.0%
Australian Dollar	USD	1.1%	1.7%	12.0%	5.5%
South African Rand	USD	0.0%	0.7%	5.9%	9.4%
Swiss Franc	USD	1.9%	1.6%	7.7%	2.7%
Chinese Yuan	USD	1.2%	1.7%	7.2%	2.8%
Commodities & Alternatives					
Commodities	USD	0.0%	0.4%	-2.6%	1.6%
Agricultural Commodities	USD	1.0%	1.1%	-2.6%	-0.7%
Oil	USD	2.0%	2.7%	-5.4%	7.6%
Gold	USD	1.9%	2.3%	16.9%	0.7%
Hedge funds	USD	0.2%	0.2%	4.0%	5.2%

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