

Weekly Digest

Week ending 19 February 2017

Inflation is up, is this an issue?

We believe that, ultimately, it's imperative to move the debate forward with respect to what constitutes 'risk' to an investor. Thinking of risk purely in terms of volatility is a disservice for investors as in reality 'risk' is so much more than a number. One of the greatest risks that many savers are taking – often unwittingly – is the risk of having insufficient funds for a reasonable lifestyle at retirement, especially when the ravages of inflation are taken into account.

While inflation may only be of moderate interest to today's investors, looking to the future, it's going to be a pivotal concern for tomorrow's pensioners. The good news is that, with sufficient time horizons, all assets have historically beaten inflation. It may be difficult to believe but this also includes cash in the UK. The real difficulty in beating inflation time series is that they are relentless; inflation is almost always positive, especially in the UK. As a result, a cumulating inflation time series nearly always goes up in a straight line, unlike investable assets which have price volatility in the form of mark to market moves.

As we know some asset classes have high price volatility whereas others are relatively low. Investing to beat inflation is difficult because of the mismatch in volatility between these different assets and the low volatility nature of inflation. As a result, you shouldn't expect to beat inflation with a month or even a year's returns - it requires a reasonable time horizon. The best way to reduce the volatility around the stable inflation returns series is to create diversified portfolios

that have a genuine suite of differentiated returns drivers contained within them. To enable this, it may be necessary to hold some assets that you do not expect to beat inflation over the medium-term but that are instead a decent stabiliser. There may be times where few asset classes display the necessary expected real return. This is a time for discipline to be applied. It would be all too easy to dominate a portfolio with the few attractively valued asset classes, but doing so would be unlikely to provide a suitable balance of risks to investors.

It is this propensity of investments to move in price that in the end helps us - these moves bring with them the potential for an asset class' valuation to deviate from fair value and the opportunity set for investors trying to beat inflation comes from a valuation focus. Other tools at our disposal that help improve the profile of returns include making use of a global range of asset classes and sub-asset classes. It's imperative to be able to identify opportunities with finesse whether that be in regional or sectoral equity markets or even a particular part of the interest rate or credit curve. Within equity markets, it's also important to make use of style factors, as this is a very effective way of using highly volatile returns streams that each have a unique stylistic tailwind to create a selection where the combination is far greater than the sum of the parts in terms of risk adjusted returns. Improving risk-adjusted returns through means such as these is an effective method to enhance the probability of achieving the desired return in excess of inflation.

The Marketplace

- Rate hike expectations rise in the US
- Inflation data shows global prices continue to climb
- US equities close the week at new all-time highs
- Euro Area GDP grows +0.4% in Q4 2016
- China sets new record for monthly lending

Market Focus

US

- Effects of broadly positive economic data and US Federal Reserve Governor Janet Yellen's relatively 'undovish' tone at her semi-annual testimonial combined to significantly increase the perceived chances of a rate rise at the Fed's next meeting in March. Bloomberg's calculated rate hike probability rose over the week to 34%, after sitting at 28% a week ago on Friday.
- Yellen commented that "waiting too long to remove accommodation would be unwise" whilst conceding that "incoming data suggests that labour market conditions continue to strengthen and inflation is moving up to 2%".
- Such incoming data included headline consumer prices rising by 0.6% (versus +0.3% expectations) over January, bringing prices to a level 2.5% higher than in January 2016 – above the Fed's 2% annual target rate. Other data showed retail sales rising by 0.4% over the month, although industrial production fell by 0.3%.
- The net effect of the above was positive for US equity markets, which, led by financials, rose 1.52% over the week to record new all-time highs.

Europe

- Notable inflation reports showed German, UK and Swiss prices rising 1.9%, 1.8% and 0.3% respectively year-on-year in January. These were the highest figures for Germany and the UK since July 2013 and June 2014 respectively, while Switzerland's was the first positive year-on-year figure since August 2014.

- The rising price data coincided with confirmation that Euro Area GDP rose by 0.4% over the fourth quarter of 2016, resulting in 1.7% growth over the full year.
- Meanwhile deadlock continues between the Greek government and its creditors amid the need for further bailout funds ahead of debt repayments owed in July; with Germany, the biggest of such creditors, reportedly stating that the IMF would need to participate in providing aid if any deal is to be reached. An estimated EUR 2.2bn of deposits have been withdrawn from Greek banks since the start of the year as default fears have worsened.
- For now, however, the effects on financial markets seem to be contained within Greece, as European equities rose 1.17% over the week.

China

- The Chinese economy did little to buck the trend of higher inflation, with year-on-year consumer and producer price inflation both rising above expectations, to +2.5% and +6.9% respectively, in January. This was the fifth consecutive month of positive PPI figures after 54 months of consecutive negative readings.
- Monthly Total Social Financing, a broad measure of credit in the economy, rose to a record RMB 3.74tn (USD 544.9bn) in January. The measure includes off-balance sheet financing, with the new monthly high reflecting the increasingly large influence of China's 'shadow banking' sector in supplying credit to the economy.

James Klempster (CFA) & Oliver Bickley

Asset Class/Region	Currency	Currency returns			
		Week ending 17 Feb 2017	Month to date	YTD 2016	12 months
Developed Market Equities					
United States	USD	1.6%	3.3%	5.2%	23.9%
United Kingdom	GBP	0.9%	3.3%	2.7%	26.2%
Continental Europe	EUR	1.0%	2.5%	2.5%	17.3%
Japan	JPY	-0.1%	1.5%	1.7%	23.1%
Asia Pacific (ex Japan)	USD	1.1%	3.3%	9.3%	28.6%
Australia	AUD	1.6%	3.4%	2.6%	23.9%
Global	USD	1.3%	2.6%	5.1%	21.4%
Emerging Market Equities					
Emerging Europe	USD	0.0%	1.2%	3.0%	34.0%
Emerging Asia	USD	0.9%	3.3%	9.4%	27.6%
Emerging Latin America	USD	1.0%	4.4%	12.3%	51.9%
BRICs	USD	1.2%	4.0%	10.6%	41.7%
MENA countries	USD	1.9%	1.5%	3.1%	23.6%
South Africa	USD	1.9%	3.3%	6.2%	25.8%
India	USD	0.0%	3.8%	9.3%	28.2%
Global Emerging Markets	USD	1.0%	3.3%	9.0%	30.7%
Bonds					
US Treasuries	USD	-0.1%	0.2%	0.4%	-1.3%
US Treasuries (inflation protected)	USD	-0.2%	0.0%	0.9%	4.6%
US Corporate (investment grade)	USD	0.1%	0.4%	0.7%	7.0%
US High Yield	USD	0.2%	0.7%	2.2%	23.8%
UK Gilts	GBP	0.5%	1.6%	-0.3%	5.8%
UK Corporate (investment grade)	GBP	0.5%	1.3%	0.3%	11.0%
Euro Government Bonds	EUR	0.3%	0.3%	-1.7%	-0.2%
Euro Corporate (investment grade)	EUR	0.2%	0.7%	0.2%	4.7%
Euro High Yield	EUR	0.3%	0.7%	1.4%	14.3%
Japanese Government	JPY	-0.3%	-0.3%	-1.0%	0.5%
Australian Government	AUD	-0.6%	-0.4%	0.2%	0.5%
Global Government Bonds	USD	0.1%	-0.4%	0.5%	-1.9%
Global Bonds	USD	0.1%	-0.3%	0.6%	-0.4%
Global Convertible Bonds	USD	0.5%	0.9%	3.0%	8.5%
Emerging Market Bonds	USD	-0.4%	1.2%	2.7%	11.3%

Asset Class/Region	Currency	Currency returns			
		Week ending 17 Feb 2017	Month to date	YTD 2016	12 months
Property					
US Property Securities	USD	-0.1%	1.6%	1.5%	16.8%
Australian Property Securities	AUD	0.4%	3.6%	-1.4%	4.6%
Asia Property Securities	USD	-0.7%	1.5%	7.1%	20.9%
Global Property Securities	USD	0.2%	2.1%	3.3%	15.8%
Currencies					
Euro	USD	-0.2%	-1.6%	0.9%	-4.6%
UK Pound Sterling	USD	-0.4%	-1.0%	0.7%	-12.9%
Japanese Yen	USD	0.5%	0.1%	3.7%	1.1%
Australian Dollar	USD	-0.2%	1.2%	6.5%	6.7%
South African Rand	USD	2.1%	3.1%	4.5%	18.1%
Swiss Franc	USD	0.1%	-1.1%	1.7%	-1.0%
Chinese Yuan	USD	0.2%	0.0%	1.2%	-5.0%
Commodities & Alternatives					
Commodities	USD	-1.4%	0.5%	1.4%	21.8%
Agricultural Commodities	USD	-1.3%	1.0%	4.2%	8.9%
Oil	USD	-1.6%	0.2%	-1.8%	61.8%
Gold	USD	0.5%	2.3%	7.5%	2.5%
Hedge funds	USD	0.4%	1.2%	1.7%	8.4%

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