

Weekly Digest

Week ending 30 July 2017

Never a zero chance

A weather forecast the other day predicted that there was “zero chance of rain”. Now, given that the investment managers are in the UK where the weather is renowned for being particularly variable – is that true, or just something the British like to talk about? It sounds like a pretty bold statement, bordering on hubristic. We’ll revisit this idea later on; what the manager’s want to talk about briefly in this piece is the outlook for equities in a rising interest rate environment.

After five years in which central banks in the UK, the US, Japan and Europe have left interest rates on hold, the US Federal Reserve has now raised interest rates three times in the space of six months and it is expected to raise them again within the next nine months. We have lift off! What does this mean for equities? The Gordon Growth Model tells us that the value of a share is equal to its latest dividend (D_0), multiplied by its growth rate ($1+g$) and divided by the required rate of return minus the growth rate ($k-g$). The required rate of return (k) is the sum of the risk free rate – i.e. prevailing interest rates – and a spread component linked to the riskiness of the investment. Therefore, with interest rates appearing on the bottom of the equation, higher interest rates result in lower share prices, other things being equal. This makes sense intuitively: if a current account is suddenly paying 3% per annum, the investor is going to need a bigger incentive to switch into equities, which means lower prices.

However, and still looking at the equation for share prices, the attractive feature of equities is that the numerator is not fixed, hence we need to understand what the outlook for growth is. If central banks are raising interest rates because we are seeing a virtuous cycle of spending and job creation which is giving rise to positive but manageable levels of inflation, then growth is likely to be increasing at the same time as interest rates which is offsetting the impact of a higher required rate of return. Therefore equities can be somewhat insulated from the move in interest rates, as has been the case in the US, with the S&P 500 index gaining 20% since the first rate hike in December 2015.

Deutsche Bank’s Chief International Economist Torsten Slok¹ – a must read for any time starved investor – shows that interest rates and share prices have become positively correlated, which means rising interest rates have not held back equities so far in this cycle. Further, with fixed paying investments suffering in this environment – something we’ve already seen over the past 12 months – equities are likely to see inflows from investors switching out of underperforming bonds.

As ever however, there is an alternative scenario – there is never a zero probability of equities going down. It won’t have escaped anyone’s attention that the US stock market, although it suffered huge losses during the 2009 financial crisis, has risen by over 300% since then and over 80% since the pre-crisis peak. The alternative scenario is one where interest rates move up too quickly, possibly as a result of central banks being overzealous or more likely as a result of an inflationary shock. If inflation and interest rates rise aggressively, this will leave consumers under pressure and demand and therefore spending will fall. In this environment, growth does not rise as quickly as interest rates or potentially even falls, and equities suffer.

Given a non-zero probability of equities going down, it is important to stay broadly diversified. The aim of portfolio construction is to build a portfolio of complementary assets that will grow and allow you to fulfil your lifetime spending needs irrespective of hard-to-predict variables like the future path of inflation.

The portfolio managers remain invested in equities but we also have some select bonds, some commodities, property and uncorrelated strategies not linked to the path of interest rates or equities. While equity multiples have steadily increased, valuations outside of the US are not yet at cyclical highs and the managers are still forecasting reasonable returns from areas like Europe, Japan and emerging markets. In summary then, we’re not predicting rain, but we would definitely not say there is a zero probability that we get some!

The Marketplace

- US GDP growth rebounds from disappointing Q1 growth
- Federal Reserve indicates imminent balance sheet normalisation
- US Senate begins healthcare legislation debate
- Brent crude rises 9.3% following Saudi export cuts
- Greece returns to the sovereign debt market after three-year hiatus

Market Focus

US

- US GDP grew 2.6% in Q2, matching expectations and up from 1.2% in Q1.
- On Tuesday President Trump received sufficient support to enable debate in the Senate regarding healthcare legislation plans to repeal and replace Obamacare. Following this, the Senate twice rejected repeal plans during the week.
- Consumer confidence rose unexpectedly, with the indicator hitting 121.1 versus expectations of 116.5.
- The Federal Open Market Committee statement on Wednesday was perceived to be more dovish than expected with 10 year treasuries falling 4.5 basis points after the statement, whilst the US Dollar index fell 0.5%. The committee stated they expect the balance sheet normalisation process to begin “relatively soon”.
- Tobacco stocks fell dramatically in the US with news suggesting the US Food & Drug Administration was planning to regulate nicotine levels in cigarettes.
- Despite a weakening US Dollar, rising oil prices, and improving US GDP growth, the S&P 500 fell 0.3% during the week.

UK

- Communication issues appear to be overhanging Brexit negotiations after EU Chief Brexit negotiator Michel Barnier told EU ambassadors that he doesn't expect the UK's target of beginning trade deal discussions in October to be met. Barnier noted the UK government has failed to provide sufficient clarity on its stance during discussions.
- UK equities fell 1.1% during the week whilst Sterling rose 1.1% versus the US Dollar.

Europe

- Brent Crude oil rose 9.3% during the week after Saudi Arabia pledged large export cuts to oil, whilst the American Petroleum Institute reported Crude inventories fell 10.2m barrels last week.
- The Euro Area composite Purchasing Manager Index (PMI) dropped more than expected to 55.8 versus expectations of 56.2, largely attributed to falls in manufacturing PMI with France and Germany disappointing.
- The Euro continued to strengthen versus the US Dollar following the apparent dovish FOMC statement, ending the week at 30 month highs of 1.1751 after rising 0.8%.
- Greece returned to the bond market for the first time in 3 years, with a EUR 3 billion five-year offering that was more than two times oversubscribed.

Asia

- China's July manufacturing PMIs were marginally softer than expected, falling to 51.4 from 51.7 in June; attributed to adverse weather conditions.

Richard Stutley (CFA) & Oliver Cooper

Asset Class/Region	Currency	Currency returns			
		Week ending 28 July 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.0%	2.1%	11.3%	15.6%
United Kingdom	GBP	-1.1%	1.0%	5.7%	13.9%
Continental Europe	EUR	-0.3%	0.0%	8.7%	17.3%
Japan	JPY	-0.5%	0.6%	8.0%	26.8%
Asia Pacific (ex Japan)	USD	0.4%	4.7%	25.4%	23.4%
Australia	AUD	-0.3%	-0.3%	2.8%	7.1%
Global	USD	0.1%	2.4%	13.3%	17.0%
Emerging markets equities					
Emerging Europe	USD	-0.1%	4.9%	8.9%	23.6%
Emerging Asia	USD	0.3%	5.0%	29.4%	27.1%
Emerging Latin America	USD	0.3%	8.0%	19.0%	19.6%
BRICs	USD	1.3%	7.9%	26.0%	28.4%
MENA countries	USD	0.1%	1.1%	5.2%	13.2%
South Africa	USD	0.6%	8.1%	16.8%	11.0%
India	USD	1.5%	6.3%	31.0%	22.3%
Global Emerging Markets	USD	0.3%	5.6%	25.1%	24.2%
Bonds					
US Treasuries	USD	-0.3%	0.2%	2.1%	-2.4%
US Treasuries (inflation protected)	USD	0.0%	0.5%	1.5%	-0.7%
US Corporate (investment grade)	USD	-0.3%	0.8%	4.6%	1.9%
US High Yield	USD	0.2%	1.1%	6.1%	10.8%
UK Gilts	GBP	-0.4%	0.4%	0.6%	-2.2%
UK Corporate (investment grade)	GBP	-0.1%	0.8%	3.3%	2.7%
Euro Government Bonds	EUR	-0.3%	0.1%	-0.9%	-3.7%
Euro Corporate (investment grade)	EUR	0.0%	0.8%	1.4%	0.5%
Euro High Yield	EUR	0.3%	0.9%	5.1%	8.4%
Japanese Government	JPY	0.0%	0.1%	-0.4%	-3.8%
Australian Government	AUD	0.1%	0.0%	2.4%	-1.8%
Global Government Bonds	USD	0.1%	1.4%	5.6%	-2.5%
Global Bonds	USD	0.1%	1.5%	5.9%	-0.3%
Global Convertible Bonds	USD	0.0%	1.8%	8.8%	7.8%
Emerging Market Bonds	USD	-0.5%	0.3%	6.6%	3.3%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	0.5%	1.1%	3.2%	-4.7%
Australian Property Securities	AUD	0.6%	0.1%	-5.9%	-15.4%
Asia Property Securities	USD	1.5%	4.3%	20.7%	13.3%
Global Property Securities	USD	0.8%	2.7%	10.9%	2.9%
Currencies					
Euro	USD	0.6%	2.9%	11.6%	6.0%
UK Pound Sterling	USD	1.1%	0.9%	6.2%	-0.3%
Japanese Yen	USD	0.2%	1.4%	5.6%	-5.0%
Australian Dollar	USD	0.9%	3.9%	10.9%	6.4%
South African Rand	USD	-0.8%	0.2%	5.0%	8.5%
Swiss Franc	USD	-2.3%	-1.0%	5.2%	1.3%
Chinese Yuan	USD	0.3%	0.5%	3.3%	-1.1%
Commodities & Alternatives					
Commodities	USD	3.0%	3.0%	-2.9%	5.2%
Agricultural Commodities	USD	-1.0%	-0.1%	1.4%	2.1%
Oil	USD	9.3%	9.6%	-7.6%	23.0%
Gold	USD	1.2%	2.1%	10.1%	-5.0%
Hedge funds	USD	0.1%	0.9%	3.5%	5.6%

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