Weekly Market Comment

8 September 2017

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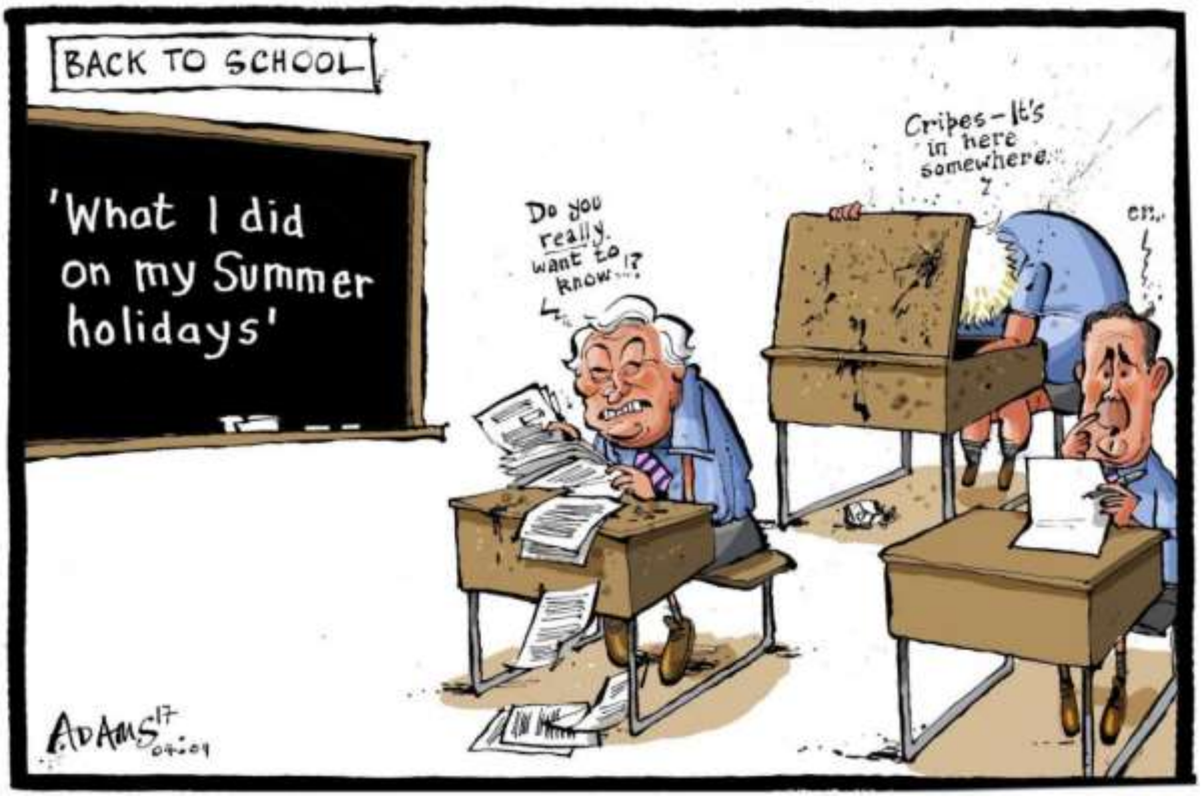


Source: Evening Standard, 4 September 2017

‘Back to school’ amidst hurricanes, earthquakes and nuclear threats

As the summer of 2017 is drawing to an end, we are relieved that much of what could have gone wrong over the summer, did not. As reported over the past weeks, the global economic recovery and stabilisation has made consistent progress, with particularly the Eurozone coming up strongly and taking over the western growth leadership baton from the US.

The same cannot be said about capital markets – and politics. Investment returns have, despite stronger economic data and corporate profit growth, only very slightly moved beyond the healthy levels they had already achieved at the end of May. This ‘market breather’ was what we had anticipated and on the back of the strengthening macro-economic outlook, we would normally look optimistically to the remaining 4 months of 2017.

That is, if it was not for politics – and now also mother nature. In purely economic terms the latter is more of a nuisance than a problem. Natural disasters create data fuzziness, as they first slow down activity levels in the affected regions, before rebuilding supercharges them further down the line.

Politics and geopolitics in particular are less predictable. Trump and European elections were the big worry points at the beginning of the year. Of those only Trump remains as a political instability factor, but given how very little he has been able to achieve thus far and how much public support he has lost in the process his fear potential regarding the outbreak of global trade wars has greatly reduced.

Unfortunately, the same cannot be said about the level of geopolitical tensions and here Donald Trump remains an uncertainty accelerator. North Korea leader Kim Jong-Un's ambitions to be recognised and respected as a nuclear arms power have begun to cast a shadow on the short to medium term global outlook.

While the US public is captivated and regionally disrupted by a particularly strong hurricane season, global security circles are nervously waiting what form of military provocation North Korea's leader may choose to mark the founding day of his nation (Sat 9 Sep).

A surprising rally in bond markets tells us that the more cautious part of the capital markets is beginning to take the threat of a thermo-nuclear conflict serious. It is positive to observe that China's leadership is all but amused and has started military exercises and missile interception drills along its border with North Korea. Less positive is to have a temperamental hot head as the top of the world's leading military power. We suspect that he won't be let near any buttons without supervision, but ultimately, we have to assume a far more trigger-happy US military than was the case under Obama.

At the time of writing on Friday, I am therefore having slightly mixed feelings as I look forward to the weekend. I will be very relieved if nothing has happened over the weekend or even better, if a Chinese/US/Russian alliance has successfully intercepted any 'fireworks' from North Korea and vows to deal more effectively with the Kim Jong-Un situation.

As this is slightly wishful thinking, I am afraid that until the North Korea threat is dealt with, the outlook until the end of the year has become much more uncertain than the flow of positive economic data recently suggested.

Falling yields, rising bond values?

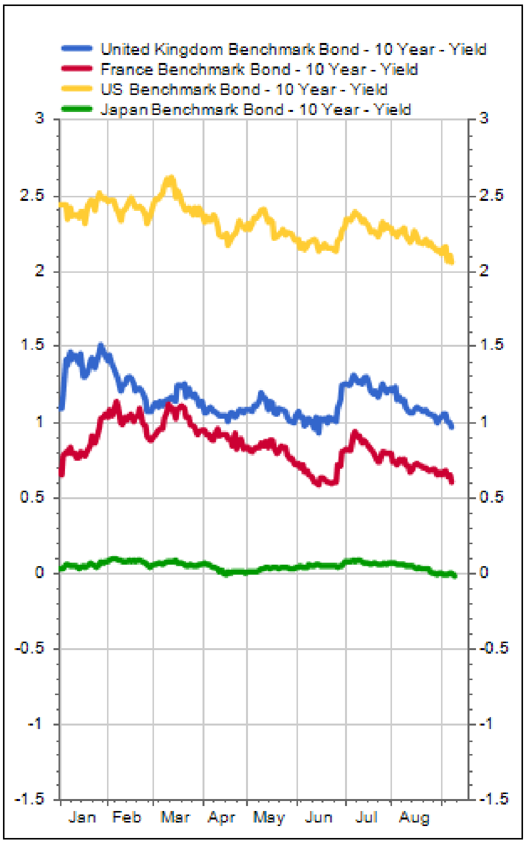
One might think that bond traders would be happy with the resumption of a bull market in their asset class. Increased investor demand for the relative safety of bonds has led to yields on bonds with a 10 year maturity falling sharply in virtually all the major markets this week and have been moving generally lower for 6 weeks.

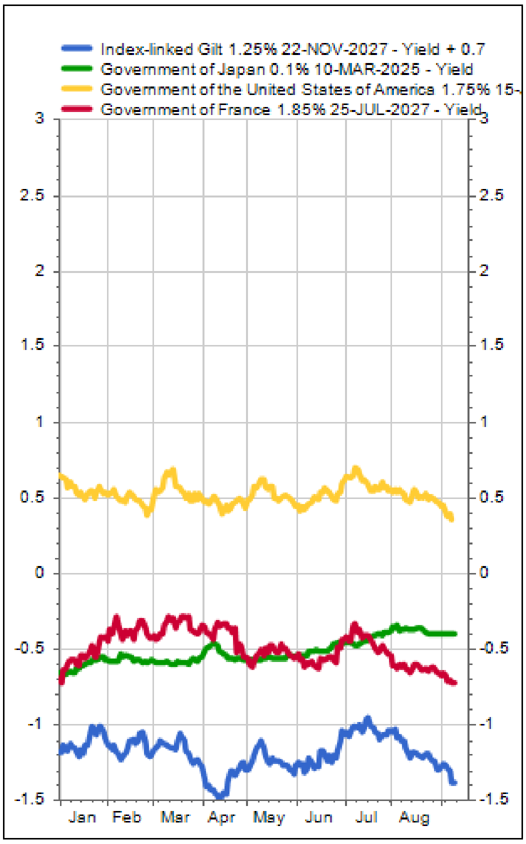
However, our experience is that most bond traders have been deeply unhappy since the various central banks became the main buyers of government bonds, which pushed up their prices and brought down their yield. This is because there are now fewer actively trading investors in their markets because the profits to be gained just by holding the bonds is zero. Gone are the heady days when bonds yielded significantly more than cash, inflation and equities. A decent bear, but not bull market might bring back the thousands of investors that left the market in the past 3 years.

Thus, most bond market makers have been eagerly anticipating the end of QE so this week's non-announcement from the ECB disappointed them deeply.

The falls in yields have been mystifying for economists given that global growth estimates have been increasing over this 6-week period, which logically should and historically usually has pushed yields up not down.

The charts below show the 2017 development of yields on government bonds across the world. The left shows the path of yields for 10 year bonds. The blue line shows us that you can buy a £100 of a 10 year gilt and get about £1 a year in interest.





The right hand chart shows the "inflation-linked" bonds. If you put £100 in the 10-year index-linked bond, you effectively get the inflation rate paid as a MINUS about £1.40 coupon (3% inflation would give you £1.60; £3 - £1.40) and you'll get 98.6% of your inflation-adjusted capital back. Put another way, you can have a fixed return of 1% on the conventional bond, but the pricing of the index linked bond tells is that inflation is expected to average 2.4% over the next 10 years and so you should expect to lose 1.4% of your purchasing power despite the 1% yield . (For the sake of illustration we have made some big simplifications in the maths and assumptions).

How can this make sense, now that the medium-term outlook for the Global economy is looking increasingly more normal and stable? Well, a lot of long-term investors are willing to ignore inflation, and rather lock in their buying power, especially if the various scenarios ahead that will determine the true rather than anticipated rates of inflation, start looking complicated and uncertain. The most difficult of such scenarios is one that includes war.

What's notable in the past 6 weeks is that all assets regarded as safe havens – not just inflation linked bonds have rallied. Gold, also known as the 'currency of fear' has likewise gained considerably (see chart below).

Gold price in US$ over the past 5 years; Source: CNBC, 8 September 2017

The best explanation for these moves seems to the fears associated with North Korea's nuclear missile threats. At the time of writing, we know that North Korea has an "auspicious" day on 9th September (NK's founding day); we can only hope that the celebratory fireworks will be kept in their garden.

One notable exception from the global picture has been the remarkable Japanese market. This has not shown the moves of other markets, despite the proximity to the problem area. Let's hope this is a sign that the rest of the world is overly concerned.

Mario Draghi – master of soothing market messaging?

One of the key events for markets this week was the European Central Bank's (ECB) monetary policy announcement.

In advance of the ECB's announcement, the markets expected no change in the main interest and deposit rates. But they were hoping for some comments and "forward guidance" on the timings of the anticipated reduction of the ECB's quantitative easing (QE) programme of liquidity injections through continued purchases of European bonds. As we have commented before, this carries considerable significance for capital markets and investors, because since the Global Financial Crisis (GFC), positive investment returns have been closely correlated with additional monetary stimulus, particularly in the form of QE.

The build-up in market expectations was largely a result of the recent strengthening of the €-Euro, which led to the assumption that this would dampen export demand and reduce the nascent inflationary tendencies across the Eurozone (EZ) through lower prices of imported goods (in other words - the opposite to what we currently experience in the UK). This in turn would reduce the pressure on the ECB to tighten monetary policy as inflation and economic overheating would clearly be less of a concern.

At this point it is worth noting that these days, all commentators appreciate the significance of the Eurozone and it is difficult to ignore the impact that the ECB and the Eurozone has on financial markets. This has not always been the case and even though the EZ accounts for ~25% of all global trade and ~15% of World GDP, only under Draghi's stewardship, has the ECB's established itself as a just as important and credible a central bank as the US Federal Reserve. Its macroeconomic policy announcement matter. The ECB's latest press announcement might have disappointed in this respect as it was – quite literally – the same as the previous announcement and policy decision in July (see below).

The €-Euro had edged back up to $1.196, ahead of the ECB's decision and has recently traded at $1.20 — its highest level since QE began (in 2015). Markets expected the ECB to "talk down" the €-Euro, by hinting at delaying its move towards further tapering back of QE in light of the currency movement. Tapering is a (gradual) reduction in the level of additional QE purchases and/or a timetable/outline for a programme of selling the bond assets on its balance sheet back to the market. Latest estimates suggest the ECB now holds >$2tn (2,000,000,000,000) of bond assets on its balance sheet – which is now larger than that of the US Fed.

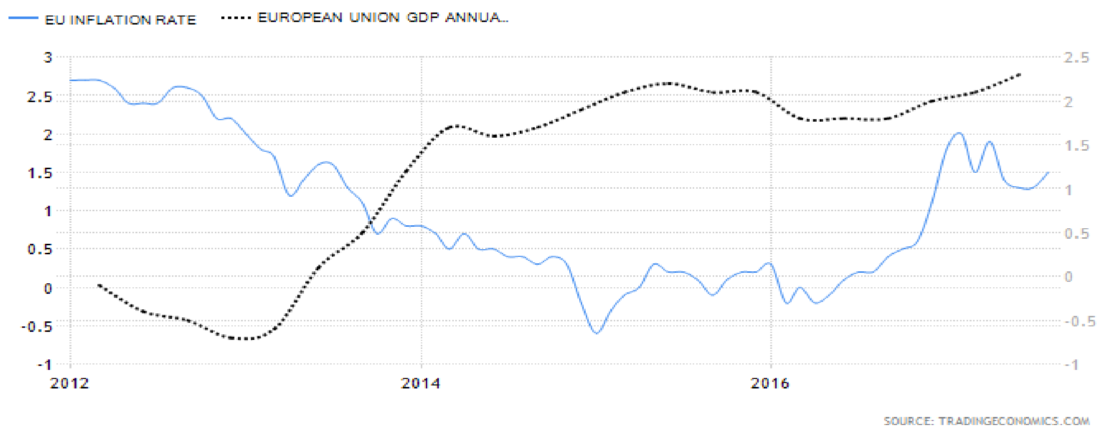
In the event, market predictions compared reasonably well with the ECB's interest rate policy, but, were a little of the mark with respect to QE and the €-Euro. The ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility should all remain unchanged at 0.00%, 0.25% and -0.40% respectively.

As for QE, the ECB confirmed that net asset purchases, at the current monthly pace of €60 billion, will continue and are intended to run until the end of December 2017. The ECB announcement reiterated that net asset purchases (QE) could continue beyond December 2017, and if necessary, could in any case be extended until there is a sustained adjustment in the path of inflation consistent with the ECB's inflation target (of 2%).

Even though this is a (*verbatim*) repeat of the previous statements, the ECB's maintenance of QE and its readiness to continue with QE beyond the current forecast date, is arguably the key element of this most recent ECB announcement.

Despite the recent pick-up in inflation in the EZ and steady economic improvement; and, the EZ has proved itself resilient to a wide-range of uncertainties, e.g., Brexit, Greece, the Italian banking sector weakness etc. At this stage it is not certain whether the EZ is wholly out of the woods, and/or whether the current level of growth is sustainable and consistent with an increase in inflation to a desirable neutral rate of 2%.

Inflation and GDP growth in the Eurozone



Source: Trading Economics, 5 September 2017

Yes, the EZ economic recovery has gathered pace after steady quarterly gains in Q3/Q4

(2016), and is also forecast to reach 2.2% (real) in 2017. However, inflation remains a little subdued and could of course be further reduced by an appreciating €-Euro. Economic growth is then actually forecast to reduce to 1.8% and 1.9% in 2018 and 2019 respectively.

Therefore, while measures of underlying inflation have ticked up in recent months, they have yet to show convincing signs of a sustained upward trend. Cost pressures, notably from labour markets, also remain fairly absent. Even though underlying inflation in the EZ is expected to rise gradually over the medium term, this may be as much a result of the ECB's loose monetary policy and QE, as a result of the ongoing economic expansion.

Even though there was a great deal of market focus on the strengthening of the €-Euro as a likely headwind to EZ growth and ECB policy, the "elephant in the room" was QE, and whether the ECB is intending to reverse QE. It is understood that the ECB has begun discussions on phasing out its QE programme and a policy decision is expected next month (October) on the when and how.

As we know, in April 2017 the ECB had already started to pair back asset purchases (from €80bn) to €60bn per month, and always had a potential end date in mind of Dec' 2017. Therefore, subject to sustained growth and increases in core inflation, it should in theory not be a shock to markets if the ECB announces next month that it will not only discontinue but begin reversing QE as early as January next year. However, given how gradually the US Fed first tapered back additional QE and has still not eve started to reverse QE, this would nevertheless be a unexpected for markets. We therefore expect it will be careful and first taper further before stopping and then gradually reversing if economic normalisation continues according to plan over the next 18 months.

Some analysts are suggesting that the tapering and then reversal of QE is being forced upon the ECB, reflecting an increasing scarcity of high quality bonds, or worse, that the ECB would run out of assets to purchase by the end of 2018 should it continue along its current programme.

Clearly, the volume of asset purchases by the ECB must in some sense be finite, and it would be more concerning for markets if QE had been exhausted and low interest rates fully exploited, without there being any positive economic effect. Fortunately, the ECB's effective management of monetary policy has enabled the EZ and its economies to gain real traction, and the (bigger) issue of a potential scarcity of suitable assets may therefore never arise.

The fact that in the press conference, Draghi never discussed the bond supply issue as he had previously, was enough for the 'hawks' (those expecting tightening) to win the day – pushing the €-Euro up. However, his caveat that currency movement required monitoring was enough for the 'doves' (those expecting delays to further tapering) to be reassured that the ECB would remain vigilant and likely avoid making a policy error of premature tightening. This would explain why the currency didn't reach new highs.

Hats off then to (Super) Mario Draghi for once again managing market expectations so masterly – and thereby further increasing the respect and credibility of a central bank that is hampered with a monetary union that had been founded on considerable structural flaws and weaknesses.

Ethical investing promoted from niche to mainstream?

Historically, ‘ethical’ investing has been viewed as an investment strategy for a ‘do-gooder’ minority who cared more about charitable parameters than investment returns. They believed that the key to ethical investment was directly contributing to a more ethical, and therefore safe, clean and productive world, through only investing in companies that don’t directly damage the planet.

In recent years, however, we have been witness to a shift in investor sentiment, which now recognises Environmental, Social and Governance (ESG) focused investing as a potential tool for enhancing investment returns, whilst contributing to the improved welfare of society and the environment. With an increasing global awareness of issues such as climate change, corporate corruption and human rights exploitation, can ESG investing legitimately still be categorized as an inferior investment tool, or has it established itself as a quality strategy for investment growth?

Incorporating sustainability metrics into portfolios is emerging as a potential device for enhancing investment returns. The growing emergence of management scandals, extravagant executive salaries, climate change and an emphasis on equal rights has driven governance and sustainability awareness to the forefront of the investment community. The crisis of 2008 was one of such examples of poor corporate governance leading to negative outcomes not just for investors, but for society as a whole.

Fig. 1; Source: US SIF Foundation, Dec 2016

Since this time, investors have gained a greater understanding of the importance of strong governance and consequently this has become an area of considerable demand growth. Portfolio Managers that incorporate (at least some) ESG criteria have grown their assets under management from $1 trillion in 2012 to over $8 trillion in 2016 (Fig. 1).

There is often a misconception that ESG aligned investment managers don’t pay attention to the same commercial fundamentals that the traditional asset managers focus on and as a result are only able to achieve limited performance due to negative screens placed on their fund objectives.

However, these negative screens can actually be seen as a positive measure, protecting the fund (and thereby improving performance) by restricting investment in companies rife with corruption scandals and weak corporate governance. This is particularly pertinent in the Developing/

Emerging Market space, where less developed regulatory supervision and outright corruption frequently lead to below potential corporate results and at worst companies' failure.

In developing markets, there is an evident trend emerging that funds observing ESG standards in their investment selection and monitoring outperform those that don't. As can be seen in Fig. 2, a benchmark constructed taking ESG factors into consideration has outperformed the ordinary EM benchmark by over 80% in the last 10 years.

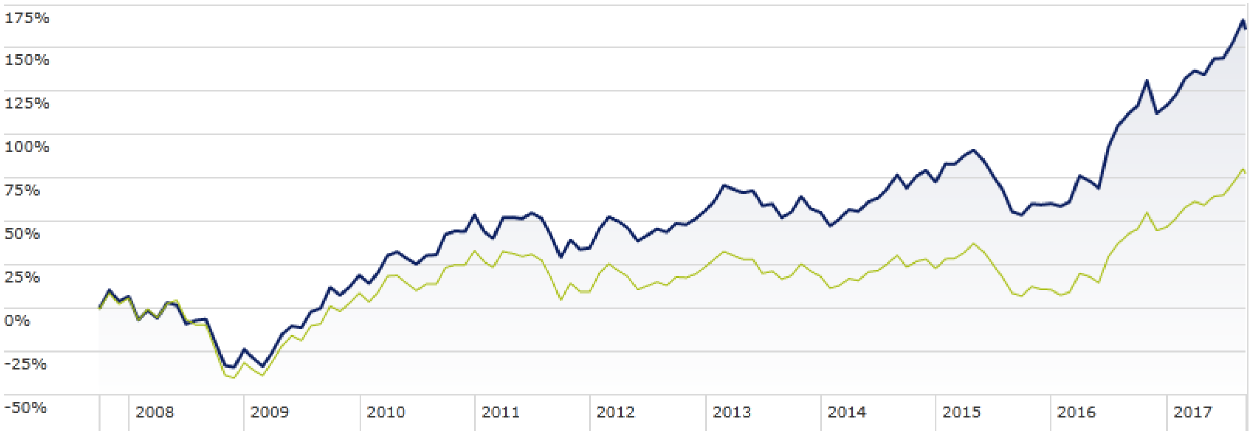


Fig. 2; Source: Morningstar, 7 Sep 2017
Blue line : MSCI EM ESG Leaders index (+160.54%),
Green line: MSCI EM index (+77.45)

This is not to say that ESG investment strategies are the only viable future option and that other approaches don't take into consideration the topics talked about in this article. More stringent corporate regulation is providing tailwinds for ESG investing in a way that increasingly forces companies to adopt stricter ESG principles and practices, thereby driving performance returns. In a world more focused than ever on the well-being of society and the environment, ESG investing certainly seems to be an option in offering strong investment growth previously perceived as a limitation on profitability.

Recent examples to reinforce the importance of strong ESG factors in stock performance can be seen through the demise of Provident Financial, Petrofac and Bell Pottinger where poor ESG management consequently led to their share prices tumbling.

The end goal of ESG investing is clear: Environmentally, to exclude those businesses that show little regard for the damaging impact of their operations on the environment; Socially, to screen out companies showing little regard for workers' welfare and communities they operate in; and regarding governance, to screen out state-run companies with little minority shareholder engagement, high conflicts of interest and concealed disclosure standards. These three factors combined are positive attributes for a company that wants to survive and increase profits in a sustainable manner. Emphasising these metrics in an investment strategy could be one way of generating enhanced returns.

As always, there are caveats and the well-known regulatory warning 'past performance is no guide for future returns' also applies with ESG driven investing. While the outperformance of the past decade is undeniable, there were several supporting factors which may or may not continue to persist in the future. Firstly, the liberal political leadership of the western economies greatly supported and subsidised ecological advancement. Certain parts of the tech sector that are seen as particularly futureproof are desperately overvalued (E.g. Tesla). Secondly, the recent commodity sector decline and fall in energy prices affected companies who would have been screened out with ESG methods; the same applies to many banks. However, if they were to make some form of recovery, which is not unlikely, then ESG would look less good. Thirdly the benefit of hindsight is a wonderful thing and many of the ESG screen back-testing results will only find true validation in future returns.

In conclusion, we cannot be entirely convinced of future return superiority of ESG investing. However, it has to be a good thing for our planet and social cohesion, if ESG is promoted from niche to mainstream and capital is increasingly allocated towards activities which should help to keep our planet in a shape and format that future generation find as habitable as we do now.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7377.6	-0.8	-60.9	↗
FTSE 250	19610.4	-0.9	-175.8	↗
FTSE AS	4043.3	-0.8	-32.5	↗
FTSE Small	5716.2	0.1	4.6	↗
CAC	5113.5	-0.2	-9.8	↗
DAX	12304.0	1.3	161.3	↗
Dow	21825.6	-0.6	-122.5	↗
S&P 500	2463.0	-0.3	-8.6	↗
Nasdaq	5928.0	-1.0	-60.6	↗
Nikkei	19274.8	-2.1	-416.7	↗

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.32	1.95	OIL	54.2	2.8
USD/EUR	1.20	1.48	GOLD	1347.3	1.7
JPY/USD	107.78	2.29	SILVER	18.0	1.7
GBP/EUR	0.91	0.48	COPPER	303.7	-2.0
JPY/GBP	6.49	0.99	ALUMIN	2107.0	-0.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.0	-6.3	-0.07
US 10-Yr	2.1	-4.9	-0.11
French 10-Yr	0.6	-10.1	-0.07
German 10-Yr	0.3	-17.7	-0.07
Japanese 10-Yr	0.0	500.0	0.01

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MICRO FOCUS INTERNATIONAL	7.1	PROVIDENT FINANCIAL	-8.8
NEXT	5.3	CARNIVAL	-6.1
JOHNSON MATTHEY	4.4	BHP BILLITON	-5.5
ASTRAZENECA	4.3	ADMIRAL GROUP	-4.8
PADDY POWER BETFAIR	4.1	MONDI	-4.8

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.6
5-yr Fixed Rate	2.0
Standard Variable	4.5
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	19.8	Brazil	182.6
US	19.3	Russia	138.7
France	20.8	China	60.2
Germany	13.4	South Korea	70.7
Japan	25.2	South Africa	170.3

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel