Weekly Market Comment

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Change of direction or gradual normalisation?

The end of the low volatility goldilocks stock market environment has been unnerving for investors, but it has also triggered a fascinating debate amongst economists and market strategist about where we may be heading from here. As a result I have had the dubious pleasure of having to analyse and read even more than usual, although at least it has been more stimulating than the previous endless musings whether markets had once again fallen into a state irrational exuberance - or not.

I can report that there is a fairly broad consensus supporting our view that the economy is in a more stable position of synchronised global growth than it has been for a very long time and that this is most likely going to continue, although most expect (or perhaps hope?) at a slightly slower rate than of late.

There is also a growing consensus that the prolonged era of stall speed growth and ever further falling inflation, yields and interest rates is ending. I thought our colleagues at MRB Partners - one of our independent investment research providers – put it rather succinctly in their latest article: *The world is not on the verge of returning to the inflationary 1970s, but the mediocre and choppy economic landscape, combined with no inflation and hyper-accommodative monetary conditions, is gone. The same is true of the heady days of ever-falling interest rates and yields, and ever-rising asset prices.*

The last bit is where the discourse between the different sides starts.
The bears argue that higher volumes of debt make the global economy so vulnerable to rising yields and interest rates that the return of even mild inflation of around 2% marks the end of this economic cycle.
The bulls on the other hand argue that this cycle is only just getting started as we finally return to the old 'normal', where companies are at long last deploying their plentiful capital to expand their productive capacity through higher productivity rather than relying on short term 'hire and fire' staffing strategies. This should keep persistent inflationary pressures arising from staff shortages at bay as CapEx investment driven productivity gains are finally returning to facilitate falling unit labour costs even as wages rise. As long as this doesn't lead to an overheating of economic conditions, we could indeed hope for the goldilocks era of cheap capital transitioning neatly to the next goldilocks era of productivity gain driven growth.

Unfortunately, such transitions do not tend to occur in straight lines, especially when capital markets have never before experienced such transition from extreme monetary ease back to more normal factor costs of funding, labour and capital investment. The most relevant concern is that either the central banks or the bond markets overshoot from the one extreme to the other, which could cause a credit squeeze that triggers a renewed economic slowdown. Another valid concern is that the recently weak US$ rebounds so strongly on the back of rising US interest rates that this turns into a once again formidable economic headwind for emerging markets and global trade in general.

The more benign transition scenario is that the above described forces become counterbalancing and thereby prevent the deterioration of necessary changes from overshooting into the opposite extremes. As I have argued here before, we are still living in an environment where we tend to overestimate the severity of cause and effect. The shocks of the 2008/2009 global financial crisis (GFC) are to blame that we have a far higher propensity to assume that we are heading for disaster rather than resolution.

This is what makes the current market environment very difficult to assess and manoeuvre. From our perspective, there is a higher probability that the end of this economic cycle is still a considerable time away than to be lurking around the corner. Yet as we transition from the post GFC slow growth era gradually back to what we knew before the GFC as 'normal', there are plenty of opportunities for market forces to lose orientation and temporarily lose faith in the longer term growth path perspective.

During such a period of reorientation we have to therefore expect more bouts of unnerving market volatility as the one we have just witnessed. We may have been a little early, when we expected this to start back in the summer of 2017, but now that it appears to have finally been recognised by the wider markets we will stick to our prudently cautious stance of slightly reduced risk asset allocations compared to our long term allocation benchmarks and industry peers. At the same time, we will continue to position portfolios in terms of regional and investment style allocations for the opportunities that also arise in such an environment of paradigm change.

Should the speed of change in inflation expectations and bond yield levels recede (as we expect) or another market correction occur without there being a notable deterioration in economic outlook, then we are likely to close our cautious position and move portfolios back to a neutral or even risk asset overweight stance.

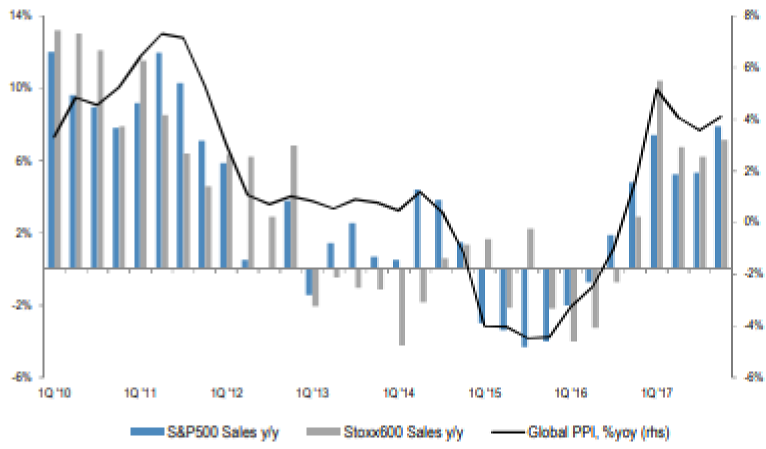
Solid global Q4/17 earnings versus jittery markets

Arguably, one of the key drivers behind the quick (if partial) recovery from the recent stock market correction has been the consistent growth in corporate earnings. While stock markets saw a sudden spike in volatility, the corporate earnings reporting season for Q4/2017 carried on in the background and painted a picture that looks at odds with falling equity valuations.

EPS (Earnings Per Share) and revenues have improved yet again all across the globe, supported by a near-synchronous worldwide economic upswing. With the recent weakness in the US dollar, it would have been reasonable to assume that US multinationals' earnings would have expanded disproportionally (as overseas earnings increased their value contribution from a US$ perspective).

But, as we will show further down, this has not been the case. However, the weaker US currency has driven up commodity prices in $-terms. This has been a big driver of the reappearance of inflation, which has now come back onto investors' radar screens. In terms of activity levels, the return of rising producer input prices (PPI), may well have had a stimulating effect for sales volumes, as the chart below illustrates.

Figure 1: Quarterly sales growth in US and Europe vs Global PPI



Source: J.P. Morgan, Bloomberg

Now that most Q4/17 reports are in, we see that EPS growth is running at a very healthy pace of between 15-17% on a YoY (year-on-year) basis in the US, Europe and Japan. This is the highest and most synchronised EPS growth rate since Q1/17 and even more impressive considering it is building on an already strong double-digit rate of growth last year. The growth is 'genuine' and not just the result of a recovery from a depressed base as was the case earlier in the cycle.

On a revenue or sales basis, Q4 remained in-line with rates of growth from previous quarters of around 8%, which points to a further expansion of profit margins to explain the double-digit increase in profits. Given the above chart, it does not surprise us to see sectors like cyclicals (materials & energy, financials, technology etc.) that have more leverage to an improving economic backdrop delivering better growth than defensive sectors (healthcare, utilities, etc.).

Regionally, Europe and Japan delivered the best results, growing EPS by 17% YoY each, but the US was not far behind with a healthy rate of 15% YoY.

In Europe, where around half of the stocks on the DJStoxx 600 have reported earnings so far, 54% of those have beaten EPS forecasts by the equity analyst community, positively surprising on average with 7% higher numbers. On aggregate – as stated – EPS grew 17% YoY, but only +10% when excluding energy – which is still enjoying a recovery effect from the previous years' oil price slump. On the revenue front, 62% of firms beat sales estimates with growth of 7%, with the contribution more evenly spread among the sectors than in the EPS figures.

Interestingly, the relative sales beats of firms in the US versus those in Europe ticked lower in Q4, despite a rise in the Euro. This suggests that, at least over Q4, European companies had been more than able to offset this currency driven negative impact on their export price competitiveness through strong operating leverage.

In Japan, all sectors posted strong growth, with growth up 17% YoY. 63% of firms beat sales estimates, delivering 9% growth YoY (the highest level since Q2-11) and, again, all 11 sub-sectors reported positive growth.

It was the US that delivered some of the best surprises. Despite starting from already higher levels, quarterly profits for firms are growing at the fastest rate in six years. That pace looks to be accelerating, as the full impact of tax cuts, renewed investment (capex) and marked improvement in business sentiment hit the bottom line.

80% of companies on the S&P 500 beat forecasts, posting 15% YoY EPS growth (falling to +13% ex-energy) and surprising by +5%. Contributions were broad based, with 10 out of 11 sectors posting positive EPS growth, led by – you guessed it – cyclical sectors like commodities, discretionary, tech and financials. Sales are also showing healthy growth of +8% YoY, almost 20% above the median level of the past 10 years. 77% of firms beat top-line estimates, at the best rate in 8 years and with all sectors contributing.

On a sectoral level, commodities have done well, due to the weaker base last year. But, stripping out those effect, the financial sector really stands out. Financial services stocks have strongly outperformed other sectors so far this year, in both Europe and America, even despite a pick-up in volatility. Financials tend to react positively to rising yields and interest rates, because it increases the spreads – the difference between what they can charge borrowers and what they must pay their own depositors.

Looking ahead to Q1-18, we cannot ignore the fundamentally strong economic backdrop facing investors today. Low and declining unemployment across the world, combined with rising activity levels is driving consumer and business demand. Global GDP growth is estimated to be around 3% in 2018, according to the World Bank. That activity is increasing demand across all sectors and a weaker dollar has been an additional boost to activity around the world.

As a result, multi-national firms are seeing good growth in Europe and Asia, which is fuelling sales gains. Banks have learnt their lessons and are well capitalised, meaning they have every incentive to lend more (on the back of improved lending margins), which should power even more growth. US firms have an added benefit from lower corporate tax rates. A Credit Suisse strategist even went as far as saying that the “fundamental back drop looks nothing short of spectacular no matter where you look”.

That’s all feeding through into increasing corporate and investor confidence. FactSet noted that the full-year 2018 bottom-up EPS estimate has risen by 7% to $157.57 a share, which represents the largest estimate increase since they began tracking this data in 1996. A total of 127 S&P 500 companies have issued positive 2018 earnings guidance, which is more than double the 10-year average of just 49.

However, a potential headwind we also cannot ignore is the prospect that the return of inflationary pressures will force central banks to raise rates faster than currently anticipated, which puts stress on all those who have taken on too much debt when money was at its cheapest in history – businesses as well as consumers (see article about the ‘Fed Put’ further down). There might be a possible secondary effect which could weigh down on equity valuation multiples (via an increase in the discount rate). This would reduce the value of future cash flows when measured in today’s terms.

One possible outcome of leaving the era of cheap credit is that this return to the ‘old normal’ results in winners and losers and therefore more differentiation between different corporate models and strategies. This should see the return to higher volatility and a focus on active stock picking. For example, who would want to indiscriminately buy all stocks in a market when higher interest expenses could pressure weak balance sheet firms, or a changing tax regime affect firms differently?

Trump’s tax cut could have one interesting and perhaps ironic impact by causing a sudden rise (and possible shortage) in the dollar, as US firms quickly repatriate some (or even substantial amounts) of the $2.5 trillion they currently hold offshore. This would see a reversal of the dollar’s recent weakness, which had – as mentioned – been a boost to the global economy.

It’s a simple concept: amid rising rates and higher interest costs, firms may seek to reduce overseas cash balances to zero (as per Apple’s stated intention with its $160+ billion) and use the offshore cash directly to fund dividends and buybacks, rather than as collateral for onshore borrowing as they have done of late.

If corporates stop recycling their cash in such a manner in short-term debt markets, then liquidity may reduce, leaving capital markets prone to more volatility. The loss of these cash-recycling corporates – who are the biggest providers of front-end liquidity – already seems to be causing stress in dollar funding markets (commercial paper market, US-OIS Libor and 2-yr swap spreads) and also looks to be behind the recent but consistent outflows in bond funds and ETFs. This is conversely causing yields to rise further, bringing turbulence to equity markets that are already worried about the higher yield/discount factor effect.

It can be easy to succumb to inflation fears, especially if central banks – and that’s a big IF – overreact. But one should remember that a reflationary environment changes a number of pricing and activity dynamics. Just as it puts downward pressure on forward looking valuation metrics, it can also lead to increased corporate pricing power and top-line (sales) improvements, along with higher profit margins – as long as firms can broadly stay ahead of cost pressures. Such factors are earnings-positive in the longer-term and can counterbalance the downward pressures on valuations. However, we also know that, whenever we undergo framework changes like this gradual return to the ‘old normal’, adjustment frictions are inevitable. So it is reasonable to assume that the ride is about to become more bumpy and uneven in progress, as investors are likely to become more selective in their investment targets.

Budget boost for the UK’s treasury

Some good news for the UK Treasury this week. On Wednesday, it was announced that unexpectedly high tax revenue in January meant the budget deficit had fallen to its lowest level since before the financial crisis. The government has borrowed £37.7bn over the past 10 months, which is £7.2bn less than over the same period a year ago and puts the Treasury on track for the lowest budget deficit in 10 years for the 2017-18 financial year. To put the cherry on top, the Office for National Statistics (ONS) showed how productivity growth was much stronger than expected in the fourth quarter of 2017, making the last six months of last year the strongest for productivity growth since before the crisis.

Unfortunately, while Wednesday saw a double dose of good news, Thursday saw the opposite. The UK economy grew less than originally thought in the last quarter of 2017, with GDP expanding just 0.4% quarter-on-quarter, down from the ONS' estimated 0.5%. Overall, that brings 2017 growth down to 1.7%, putting Britain bottom of the pack for the G7 economies. In another blow, growth in business investment was flat over the same period.

Analysts at Deutsche Bank have put the sluggish growth down to weakness in the UK's traditional "domestic growth engines" – the aforementioned business investment and (perhaps more importantly) consumer demand. In absence of these factors, Britain's economy has been supported by the strong global growth environment. In particular, positive momentum in the Eurozone is having quite an effect here, as demand for British exports is being bolstered by EU growth.

What should we make of these conflicting data points? On the one hand, we've got an improving situation (particularly for the government) while, on the other, the end results are still lagging. The contrast is particularly jarring considering that the deficit reduction came from the revenue side rather than the spending side. This latest surprise on the budget originated from a surprise boost to tax revenues, which amounted to £12.9bn more in January than had been expected providing the government with a welcome £10bn budget surplus for the month.

January revenues are always high, due to the timing of the tax return payment deadlines for the previous tax year, but even considering that, last month was still a particularly good one. Last year, such payments were especially large, but many thought this was due to a changing tax rate which incentivised businesses to register more profits under the 2015-16 tax year. So, it was expected that revenues would fall back substantially this year, but with the latest figures it looks as though last year's artificial boost may not have been as big as originally thought.

According to the Office for Budget Responsibility (OBR), the welcome boost to public revenues will lead to a "significant" upgrade to their outlook for the economy when it's released in March. This comes just four months after the OBR delivered a substantial downgrade to their outlook for Britain. Their November forecasts, which Treasury officials described as causing a "bloodbath" in the public finances, were predicated largely on a downgrade to expected productivity growth, which has been extremely sluggish ever since the financial crisis.

In that sense, the other good news – the positive surprise on productivity in Q4 2017 – will likely be even more significant for them. When the OBR released their November forecasts, we commented that they may have become too pessimistic on productivity, and that this might lead to a positive surprise on growth. They will likely think it a little too early to tell whether their long-term outlook on productivity was wrong, but the early signs are indeed looking that way.

The perplexing side of the story is that, while there indeed was a positive surprise on productivity, this didn't translate into a boost to growth. No doubt the Bank of England will be taking note of that peculiarity. Recently, the BoE took a decidedly hawkish turn in their rhetoric, commenting that, with the usual growth engines firing up, they should switch their focus to inflation, making sure price inflation does not upset economic growth prospects further down the line. But now that growth has come in weaker despite stronger-than-expected productivity, they could potentially want to see how things play out over the next few months before acting on interest rates.

Of course, what the BoE does will depend largely on what the Treasury does. And on that front, we expect some change of policy from Mr Hammond. This government has already tried to break from the austerity policies of the Cameron-Osbourne days, but they haven't exactly done so with much enthusiasm – focusing more on slight fiscal expansion without fiscal stimulus. But the latest budget developments might give them some freedom to do just that.

At the June election, the Labour party hacked away at Theresa May's parliamentary majority on a firmly anti-austerity ticket. And with the fall of PFI firm Carillion, similar troubles at Capita and – most importantly – the ongoing crisis in the NHS, it's fair to say that public opinion is calling more for providing decent public services than balancing the budget. Now that the Treasury has some leeway, they might just have to answer that call.

Doing so would almost certainly result in a more hawkish BoE, but, all things considered, that might not be such a bad thing. More than 10 years since the financial crisis, a return to a productive economy with an expansionary fiscal policy and a more 'normal' monetary policy might be welcome. As such, we have updated our view about further UK rate rises to expect the next rise for March, rather than later in the year. However, given the sluggishness of the UK economy, such a March rate rise may remain the only one the BoE might want to do in 2018.

The end of the "Fed Put"?

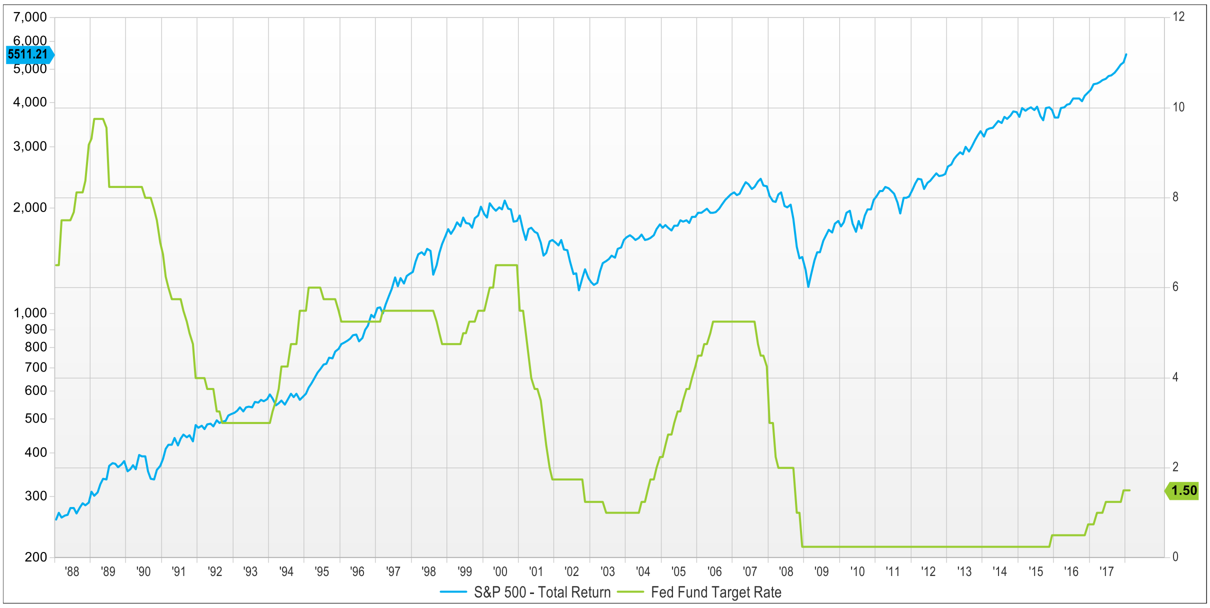
With the early February stock market sell-off widely blamed on rising yields from returning price inflation, the release of the minutes of the US central bank's rate setting committee on 31January were even more in the focus of investors than they are normally. So, why is it that stock markets pay so much attention to central banker actions, when an outsider would struggle to see the significance for stocks of small incremental changes to the interest rate at which banks can borrow short term funds from the central bank? We discuss and explain below why it is that markets have come to ascribe so much relevance to the rate setters as they have.

The US Federal Reserve (the Fed), as the central bank of the United States, has a "statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates." (FOMC minutes, 31 Jan 2018). They have a few levers to pull to help pursue these goals; most frequently employed is the Fed funds rate, short term interest rates which are put up or down to broadly try and raise or lower the general cost of borrowing and curtail or boost spending as a result.

In the wake of the 2008/2009 global financial crisis (GFC), however, central banks approached the lower bound for interest rates (I.e. got ever closer to 0%) and required other tools to encourage sluggish economies. This led to "Quantitive Easing" (QE) – the mass purchase of Government (and non-Government) debt through central bank created money, to lower yields on longer maturity bonds with similar desired outcomes aims to cutting interest rates further. Or, putting it differently, while interest rate changes only influence short term cost of finance, QE introduces the ability for the central bank to alter the cost of long term lending.

How these tools have been employed in the wake of stock market crises has led to scenarios like the "Greenspan Put" since the late 1980s, where the Fed cut rates in response to downturns in the stock market rather than in economic activity. The aim of these rate reductions was to stabilise risk asset values, before their negative wealth impact undermines consumer and business confidence and actually leads to reductions in economic activity levels. This effectively insulated risk asset investors to some extent, as they came to expect that central banks would come to their rescue should asset prices fall significantly. They were so confident that liquidity would be provided by central banks (in the US and Globally - remember Draghi's "whatever it takes" moment in the teeth of an existential crisis for the Eurozone), that it acted as quasi-insurance on their positions, in the same way a put option would (which comes into the money when prices fall below a certain pre-set threshold). If things went bad, the rates at which companies could fund themselves would be decreased, and their consumers would be able to borrow more cheaply, increasing demand and, therefore, 'justifying' high valuations.

This strategy appeared to have been continued by Fed Chairs Bernanke and Yellen, as interest rate cuts coincided with times of stock market stress such as following the Dot-Com crash of the early 2000s and the more recent Global Financial Crisis, as seen in the yellow line below (the blue line being the S&P 500).

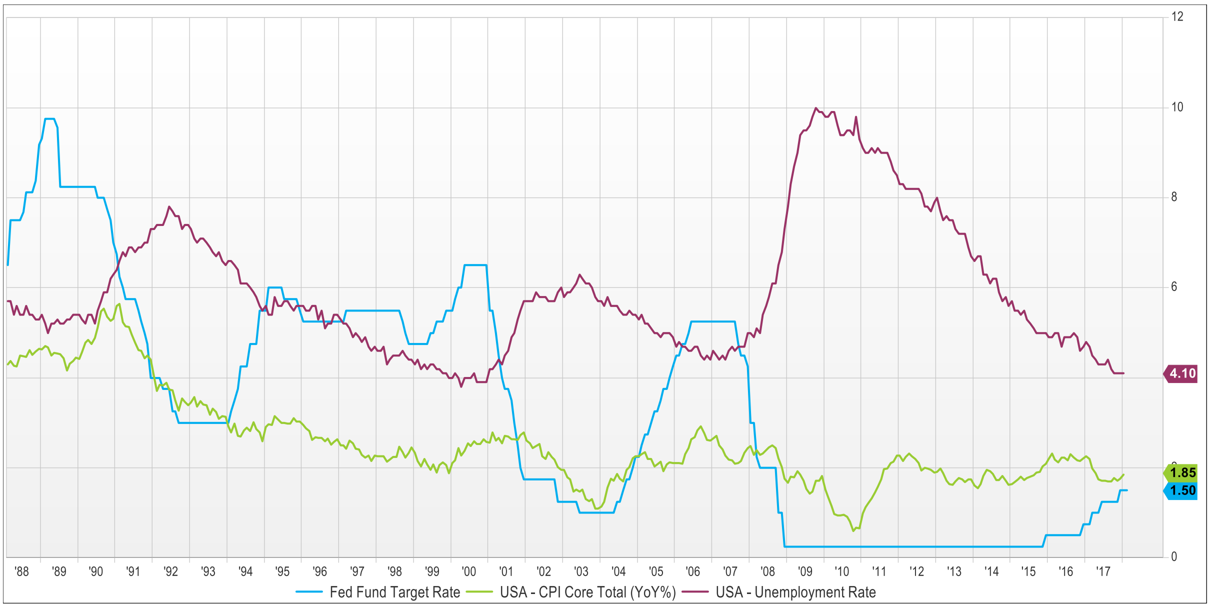


Source: Factset

But all that may be about to change…

The Fed have repeatedly made their intention clear to raise rates to what many investors would consider normal, with their "dot plots" consistently higher than those implied by markets (dots plots are long term estimates of the Fed rate, where each voting member's expectation of future rates are represented by a dot on a forward-looking chart). This now seems to be coming to pass; rates have been rising slowly but surely over the last year and look set to continue, following the recently released minutes from the January meeting. Many news outlets picked up on the phrase "A majority of participants noted that a stronger outlook for economic growth raised the likelihood that further gradual policy firming would be appropriate", towards the back of the document.

Indeed, when looking at the US economy outside of the confines of asset price performance, it is hard to argue against this position. In the chart below, we can see that unemployment is at or near 30-year lows. Meanwhile, core inflation is hovering around average levels of the last two decades (with a likelihood of it picking up in the near term thanks to weak USD and wage pressures). This hardly seems like an environment in which extraordinary support is needed from the Central Bank, even when considering their likeliness of tolerating a moderate overshoot (given how low headline inflation has been over the last decade in aggregate).



Source: Factset

While we believe there are reasons to think global growth may slow somewhat, we don't see a recession looming and overall the US economy appears to be in rude health by many metrics. The effect on asset valuations may be more negative however. Discount rates, interest burdens and input costs should start to creep up, while markets are at somewhat elevated valuation levels relative to their history. We certainly think that, as uncertainty around corporate balance sheets increases, so should volatility, and equity market sell offs (small and large) will become more frequent.

The market has started to digest this potential changing of backdrop; we have seen volatility picking up across asset classes, and a sharp but short-lived sell off in equity markets in recent weeks. During this sell off, William Dudley (New York Fed Chair) was asked by Bloomberg what he made of the fall in markets, and replied with "So far I'd say this is small potatoes,". A 6% sell-off in US markets, once the dust had settled, may indeed be a minor setback in the face of a decade-old bull market for equities.

We wrote here before that we are beginning to suspect that central bankers have become more concerned about asset price inflation than they used to, on the basis that it may be just as disruptive to economic stability as excessive price inflation. Alternatively, they may have come to suspect that continued low interest rates and loose monetary policy are at this point doing more harm than good to the further economic development and have increased their willingness to raise rates regardless of nervous capital markets.

In either case, we expect that a historic change in Fed attitudes towards asset values and an outright abandonment of the 'Greenspan Put' doctrine might cause a little more indigestion and longer adjustment period for investors than what we have experienced so far.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7233.7	-0.8	-61.0	→
FTSE 250	19757.2	0.1	23.6	→
FTSE AS	3985.2	-0.7	-27.1	→
FTSE Small	5721.5	-0.7	-42.5	→
CAC	5311.7	0.6	30.2	→
DAX	12484.9	0.3	32.9	→
Dow	25123.0	-0.3	-77.3	→
S&P 500	2721.2	-0.4	-10.0	→
Nasdaq	6821.7	0.4	26.8	→
Nikkei	21892.8	0.8	172.5	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	14.8x	13.6x	17.1x
FTSE 250	2.8	17.3x	14.0x	17.0x
FTSE AS	3.8	15.0x	13.7x	16.7x
FTSE Small	3.1	10.5x	-	-
CAC	2.9	15.7x	14.4x	15.6x
DAX	2.6	16.4x	12.8x	15.7x
Dow	1.9	22.7x	16.6x	15.3x
S&P 500	1.8	21.9x	17.0x	17.6x
Nasdaq	1.0	26.4x	20.6x	20.3x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
CENTRICA	12.9	RECKITT BENCKISER	-9.9
BT GROUP	6.1	WPP	-7.7
BARCLAYS	5.1	FRESNILLO	-6.3
SSE	4.6	BAE SYSTEMS	-6.0
RSA INSURANCE	4.4	SHIRE	-5.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.40	-0.40	OIL	66.9	3.1
USD/EUR	1.23	-0.90	GOLD	1328.2	-1.4
JPY/USD	106.68	-0.44	SILVER	16.5	-0.7
GBP/EUR	0.88	0.45	COPPER	321.8	-1.4
CNY/USD	6.34	0.07	ALUMIN	2185.0	0.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.524	-3.6	-0.06
US 10-Yr	2.882	0.3	0.01
French 10-Yr	0.931	-2.3	-0.02
German 10-Yr	0.656	-7.1	-0.05
Japanese 10-Yr	0.053	-10.2	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.5
5-yr Fixed Rate	1.7
Standard Variable	2.0
Weighted Average Interest Rate (BoE)	4.29
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet 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