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Q2 MARKET RECAP

2016

The blueprint for economic activity that has become established over the past few years in the United States has been for growth to weaken during the first three months of the year and then to recover over the remaining nine. So far, 2016 is proving true to form.

Following a very dull opening quarter, the indications are that the economy reaccelerated during the quarter to June. In all probability, this pattern has been largely the result of inadequate seasonal adjustment by government statisticians. Nonetheless, it has had an influence on the way that economists have commented on, and financial markets have reacted to broader macro themes.

Every year, we seem to go through three months of anxiety that the US is about to undergo a more prolonged slowdown, before sighing with relief that it was only temporary and probably illusory. In the current year, the weak first quarter had greater impact on sentiment because there was already concern that western economies could suffer negative feedback from the problems that had become increasingly manifest during 2015 in emerging economies. And it was not just in financial markets that we saw a reaction to such worries – they have also had an impact on policy makers.

In the US, the Federal Reserve (the Fed) had outlined a profile for interest rates that incorporated four increases during 2016, taking rates 1% higher by the year-end. This seemed to us to be a sensibly paced continuation of policy normalisation that began with the first rate rise of this cycle in December last year. However, nervousness in financial markets brought an immediate tactical withdrawal by the Fed, and it is currently projecting only two rate increases over the year.

This provides an important insight into not just the Fed's thinking but into that of most central banks in advanced economies – that they still see significant vulnerability to negative shocks and they are still looking for excuses not to tighten.

Our concern remains that, in judging the balance of risks to be weighted heavily on the downside, there is a risk that central banks will ignore for too long trends that suggest it is now appropriate to be tightening, albeit at a very gentle tempo.

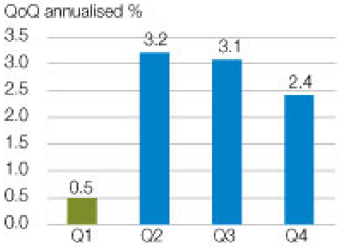
No sooner had financial markets reassured themselves that the US was not about to implode, another disturbing spectre tested their nerves: the possibility that a referendum on UK membership of the European Union could result in a vote to leave. Initially, markets seemed fairly phlegmatic about this possibility, seemingly on the assumption that Brexit was highly unlikely. However, as polling day edged closer and the outcome became more difficult to call, nervousness increased. The debate became increasingly acrimonious, with both sides making bold economic claims. That the outcome could have significant economic consequences was not to be doubted. Being certain what these might be was clearly more contentious.

Indeed, we see the referendum as having been essentially on a political question with potentially significant (but somewhat unknowable)economic ramifications, rather than viceversa. The vote – in favour of leaving the EU – came as a shock to world markets. Nonetheless, the initial reaction was not as extreme as it might have been. Near term, the result increases economic uncertainty and adds to the downside risks in European economies. At the very least, this provides policy makers in the US and UK with a further excuse to keep rates on hold. In the UK there is an additional possibility that rates will be cut or that there will be additional quantitative easing (QE), depending on how economic and financial conditions change.

At the same time as the Brexit debate was beginning to dominate the headlines, there was another important development that began to influence sentiment in financial markets. The slump in the oil price between mid-2014 and early-2016 had been increasingly seen (erroneously in our view) as a potential bellwether for the global economy.

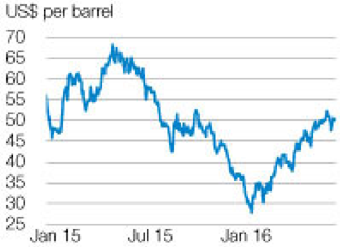
So, the rebound in the price from under US$30 per barrel to around US$50 was taken as a positive sign, allaying some of the more exaggerated fears. In fact, recent gyrations in the oil market have likely been more the result of changing supply conditions than of shifts in demand. However, where reassurance was required, it was gratefully received.

US quarterly GDP growth (average of 2013 to 2015)



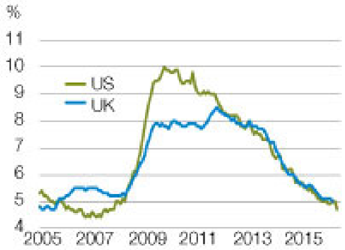
Source: Datastream.

Brent crude oil prices



Source: Datastream.

US and UK unemployment rates



Source: Datastream.

So where does this leave us? Our view is that world growth in 2016 will be at a similar pace to that recorded in 2015, albeit the risks to this assumption are negatively skewed. Within this, our expectation is for the US and UK to grow slightly less quickly, but for the EU to register a modest improvement. Against this backdrop, we believe that emerging economies, both manufacturers and commodity producers, will stabilise and possibly see a slight pickup in momentum in the second half of the year.

Japan, on the other hand, seems likely to remain mired by the deflationary forces that have beset it for the last two decades, with little evidence that Abenomics, QE or negative interest rates have had any fundamental impact.

But this is not quite the end of the story. In three major economies, there is a growing hazard: labourshortage. The US, UK and Germany all have exceptionally low rates of unemployment but continue to have strong demand for labour. To date, this potentially inflammatory mix seems to be having only a modest impact on labour costs. However, it seems unreasonable to expect this to continue to be the case (unless growth undershoots and labour demand diminishes). Indeed, we will have to come up with some radical new analysis to explain why a persistent tightening in labour market conditions is not leading to faster wage inflation. So far, core inflation rates have edged up only modestly in both the US, UK and Germany.

Nevertheless the risks seem firmly in one direction, and we expect to see further signs that domestically generated inflation is picking up in all three countries.

We suspect it is a question of timing: of when, not if. And if it proves that 'when' is sooner than currently assumed, central banks will be tested. In this regard, the Fed's central projection of a yearend unemployment rate of 4.7% and the Bank of England's (BoE) median forecast of 5.0% already look unrealistic against current rates of 4.7% and 5.0%, respectively. Indeed, it would take either a slump in growth or a dramatic recovery in productivity for unemployment in the US and UK not to be appreciably below these rates by the end of 2016.

This suggests that both the Fed and the BoE would have been raising rates by the year end, had it not been for the Brexit vote. Following the vote, the policy bias in the UK is likely to be towards easing, at least in the short-term. The European Central Bank on the other hand, is likely to remain in easing mode for rather longer, as a result of more equivocal economic trends elsewhere in the eurozone. For the BoE, the decisions will be more difficult, as it will have to weigh short-term developments against what it perceives to be the medium term Brexit risks.

As previously mentioned, financial markets, over the quarter, were for the first part relatively sanguine. Oil prices continued to rise from their lows in February to almost double by the end of Q2.

The ongoing correlation of risk assets (equity and credit markets) to oil, ensured equities were wellsupported while credit spreads in investment grade, high-yield and emerging markets tightened. The main sources of movement were seen in currencies and bonds. Sterling strengthened ahead of the Brexit referendum and government bonds such as UK and US 10-year yields had large trading ranges of 0.4 to 0.5 basis points while European periphery bonds moved wider amongst a flight to safety. For instance, the Swiss 10-year bond reached a historic low yield of -0.6% per annum, and Switzerland came within a whisker of being the first country whose entire bond market offered negative yields.

This calm came to a shuddering halt as the UK voted to leave the EU. Markets had taken heart in the lead up to the election from polls that showed increasing support for the 'remain' vote, leading to stronger equity markets and taking sterling to a 2016 high (versus US dollar).

However, as the UK's decision to leave the EU became apparent, markets reacted violently around the world with defensive assets and currencies appreciating, and riskier assets declining, as investors digested the magnitude of he vote and the likelihood that uncertainty was likely to persist for some time impacting not just investor's risk appetite but economic behaviour.

Sterling was sold off immediately reaching multi-decade lows, losing over 10% from the pre-vote highs, paradoxically supporting the FTSE 100 Index (due to the significant foreign earnings component) relative to continental European markets.
With uncertainty likely to be evident for some time across a number of fronts (including economic and political) we would expect market volatility to continue which may give rise to longer-term opportunities.

Commentary first published on 15th July 2016 by Richard Jeffrey, CIO, and Kieron Launder, Head of Investment Strategy at Cazenove Capital Management.

The referendum is over and 'Leave' won by 52% to 48%. A surprise result perhaps not predicted by pundits and experts alike, has led to a political, economic and diplomatic trauma not only for the UK, but also for Europe and perhaps the wider world.

No doubt the results will occupy a number of essays and PhDs from political scientists for years to come, but for now uncertainty has increased. Investors are trying to make sense of what has happened and what does the future hold?

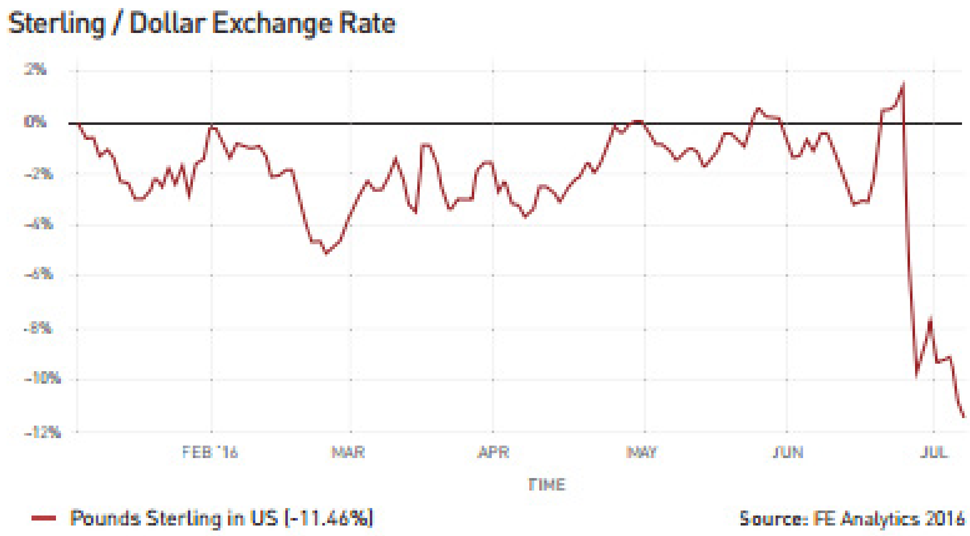
Let's look at the politics first. The referendum exposed clear splits between London and university cities, and the rest of the country, with Scotland and Northern Ireland firmly on the 'Remain' side. Another independence vote in Scotland is not out of the question and what of the relationship between Ireland and the rest of the UK? These are longer term questions.

Of more immediate concern is a political vacuum in the next few months. To have two leadership contests in both of the major political parties at the same time is fascinating and may increase the possibility of a general election earlier than expected. Further afield there are several elections in Europe over the next eighteen months. Will other countries want to have their own referendums and what will this mean for the future of the EU itself?

Finally the US election in November. Is the 'Leave' vote in the UK a harbinger of an overturning of the established order in the US with the rise of Donald Trump? It appears that politics may be the driver of the economic cycle in the near future.

As expected sterling was the first to react to the vote. From a value of $1.50 at midnight of the day of the referendum, it fell dramatically to $1.33 as the day progressed. What are the effects? Despite the headlines of a "weak" currency it is not all bad news. Exporters and companies with large overseas earnings will find their products cheaper to sell and their profits rise upon conversion to sterling. This perhaps explains the rally in the FTSE100 index during the past week. With approximately 80% of the earnings of FTSE100 from overseas, profits should rise. However inflation is expected to rise as imported goods become more expensive.

The Bank of England has missed its target of 2% inflation for some time. It may now face a rise in inflation to perhaps 3% to 4%.



A rise in interest rates is the "normal "response to an overshoot of inflation. However the UK economy is now forecast to slow as the uncertainty over politics, our trading relationship with Europe etc, may result in companies deferring investment, the consumer to rein back spending and perhaps house prices to fall. With the consumer accounting for three quarters of the UK economy this should not be overlooked. To offset the slowdown, the Bank of England is now expected to lower rates from the current level of 0.5% and perhaps worry less about inflation.

Meanwhile what about the rest of the world? US dollar weakness at the start of the quarter lifted emerging markets and commodities. However, with its safe haven status the dollar has now strengthened. Will this cause problems for emerging markets similarly to a couple of years ago, time will tell? Similarly recent strength in the yen does not help that country's exporters. Will Japan take action to stem its rise?

Uncertainty prevails and it may be some time before valuations and fundamentals move to ascendancy once again in terms of looking at markets. At the moment sentiment rules, which makes investing difficult. At such times it is useful to re-examine risk appetites and maintain a diversified portfolio.

Commentary first published on 29th July 2016 by Simon Brett, Director & Chief Investment Officer at Parmenion Investment Management.

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