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POINTS OF VIEW

A WORLD OF GREATER-THAN-NORMAL UNCERTAINTY

We have seen some notable political events over the past year. What has marked these out from the more run-of-the mill happenings is that they have introduced greater-than-normal uncertainty. There is a rather trite comment often made by economists and strategists that markets hate uncertainty. In fact, uncertainty is vital to the effective operation of financial (and other) markets.

It is only with different opinions about the future, at whatever level this may become manifest, that we can have effective two-way prices. With certainty, we take away the different probabilities that individuals might ascribe to different outcomes and, therefore, any pricing of risk.

In the statistical world, risk refers to volatility. While a particular outcome might be generally expected, given past experience there is a risk that the outcome will be greater or lesser. Generally speaking, statistical estimates of risk are dissociated from whether one outcome might be considered better than another – they are decidedly not value judgements. However, as individuals, we regard risk in a different way. We are rarely neutral with regard to the impact that different outcomes may have on us. And the way we react to perceived risks is not necessarily in line with the probability of different outcomes actually occurring. So, although many people may believe they have a positive attitude towards risk, in reality they are probably not even risk-neutral. While the probability of making 50% on an investment might be equal to the probability of losing 50%, the way we perceive these outcomes will tend to lead to much greater focus on the damaging impact of the potential loss. It may be risk taking that drives advancement, but it is risk aversion that keeps us alive.

Focus on negative consequences

Returning to recent events – in particular, the outcomes of the EU referendum and the US presidential election – they are being regarded as introducing more political and economic risk. And this has to be true. However, there has been much greater focus on the potentially negative consequences of these events – the perceived threats to our national and individual well-being – than the possibly positive effects. Naturally, we fear the impact of disrupting the status quo, and tend to assume that due to this disturbance we will suffer a negative impact. Moreover, to the extent that many people were entirely happy with the existing state of affairs, they do not ascribe a particularly high value to the potentially positive impact of change. But if fear of disturbing the existing way of things were always to determine our decisions, there would never be progress – political, economic, technological, or otherwise.

Implications

There is a further problem for many of us when considering the implications of events such as the election in the US of Mr Trump or the UK's decision to leave the EU. While we may well not like the political and/or social implications of these events, we need to be careful not to allow our concerns at one level to have an overly prominent influence on our interpretation of the consequences at another.

So, many people might have concerns about some of the more contentious statements that have been made by the new US President. But this does not mean that his policies will necessarily harm the US or even world economy. Rightly, we should be concerned that a change of political direction could undermine free trade. However, we should also recognise that we are not in a world of free trade. So, it is entirely possible that in disturbing the current status quo, we actually make progress towards this ideal, rather than regress.

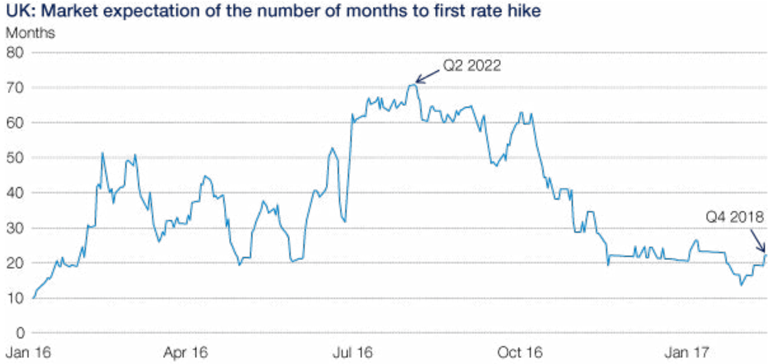
Yet given our inbuilt predisposition towards believing that what exists at the moment seems to work, we tend to take the view 'better the devil we know'. Equally, the political worries that many have over Brexit are perfectly rational. But these do not preclude a positive economic outcome for the UK, even in the shorter term. So I suspect that near-term growth expectations for the UK economy are much too low. And, turning to financial markets, expectations that are biased by non-economic/financial considerations will tend to give rise to opportunities.

First published on 23rd January 2017 by Richard Jeffrey, Chief Economist at Cazenove Cpaital Management.

THE FUTURE OF INTEREST RATES

Following the Brexit vote, the Bank of England (BoE) cut its official interest rate by 0.25% in August and signalled the potential for another cut by the end of 2016. The BoE warned of a murky economic outlook as it slashed its 2017 UK growth forecast to 0.8% (from 2.3%) and suggested that the unemployment rate would reach 5.6% by the end of 2017 (from 4.9%). At one point, market expectations for the UK's first interest rate hike were pushed forward as far as the second half of 2022.

UK: Market expectation of the number of months to first rate hike



Source: Bloomberg.

After a temporary dip in sentiment indicators in July, UK economic activity has proven surprisingly robust. Indeed, for 2016 as a whole, the UK was the fastest growing economy in the Group of Seven (G7). Better growth prospects, along with the rising trend in inflation, have led markets to reduce significantly the expected moment of the next rate increase by four years to the start of 2017.

In its latest Inflation Report in February, the BoE raised its projections for GDP growth (based on market interest rates path) to 2.0% in 2017 (from the 1.4% it forecast in November) and to 1.6% (from 1.5%) and 1.7% (from 1.6%) in 2018 and 2019, respectively. According to the BoE, the upgraded outlook over the forecast period reflects the fiscal stimulus announced in the Chancellor's Autumn Statement, firmer momentum in global activity, higher global equity prices and more supportive credit conditions, particularly for households. In reality, however, the BoE had previously been way too pessimistic.

Interestingly, the BoE now believes there is more slack in the economy and has lowered its estimate of the equilibrium unemployment rate to 4.5% from 5%. It believes some degree of remaining slack in the economy and only modest productivity growth will keep wage growth relatively subdued. Conveniently, you might think, this implies the unemployment rate can fall further without generating as much domestic inflation pressure as previously thought. Accordingly, inflation projections saw insignificant revisions relative to growth. CPI inflation is expected to pick up to 2.8% by Q2 2018, mainly due to the effect of weaker sterling, before falling back gradually to 2.4% in three years' time. It should be added, however, that inflation will be above the 2% target for the whole of the forecast period, although the Governor claimed this would be solely the result of previous sterling weakness.

We think the BoE has demonstrated its inflation tolerance by "shifting the goal posts" and may continue to look for excuses not to raise interest rates. The testing time will come if wage growth strengthens more than expected later this year. The supposition that there is more slack in the economy than previously thought keeps the central policy line at neutral for now. However, there is a clear risk that productivity does not improve as forecast by the BoE and that a continued tightening in the labour market results in greater than expected wage inflation. This would push up domestically-generated inflation and would increase the pressure on the MPC to raise interest rates earlier than markets currently anticipate (by the end of 2018).

First published on 15th February 2017 by Janet Mui, Global Economist, Cazenove Capital Management.

TRUMPONOMICS: THE GOOD, THE BAD AND THE UGLY

Donald Trump may have only just arrived at the White House, but he's certainly making his presence felt. We rather hoped that the aggressive and antagonistic pre-election Trump would morph into a slightly less belligerent president. Not so. In fact, he looks set to follow through on most of his promises – for better, and for worse.

While we may not agree with his approach, he has acted quickly on what he said he was going to do. This gives us confidence that his pro-business policies will also follow through, and equity markets will respond well to that. However, markets are also capable of reacting emotionally, deserting rational logic in the immediate aftermath of surprise announcements. We should therefore be wary of how they will react to the unpredictable nature of the man himself.

Trade

Trump is able make unilateral trade decisions, and the potential impact of his proposed tariffs, plus the abolishment of existing trade deals, remains uncertain. On the one hand, US-based employers and manufacturers should benefit in the short term. But stemming the flow of cheaper imported goods will likely give rise to inflation, and the average US consumer will be able to buy less as a result. At the same time, other countries, such as China, could impart their own tariffs on the US, making it more difficult for American businesses to export their goods.

Interestingly, Trump appears to be subtly trying to devalue the dollar (by stating that the euro is undervalued, for example), presumably with the intention of making the US more competitive on the international stage. This will be a short-term move, and a clever one if it pays off.

Immigration

On the face of it, immigration policies are likely to have little impact on financial markets. In reality, the reverse could be true. Changing demographics are having an effect on productivity in the western world, with a significant rise in retirees relative to the rest of the workforce. There are only two ways of reversing this trend – increasing birth rates (which will take time to positively impact productivity), and immigration. While Trump's changes to immigration have so far yielded an emotional response as opposed to an economic one, the longer-term impact of closing borders could have far-reaching consequences.

Infrastructure spending

Trump's intention to cut taxes while funding significant infrastructure investment has certainly had the desired effect on global equity markets. They have quickly priced in higher future US growth. The promise of new airports, roads, bridges – and a new wall – will provide jobs and prosperity in the short term, and should improve productivity in the long term. Of course, it comes at a cost, and only time will tell if rising GDP will offset Trump's ambitious spending plans (currently at around $5 trillion, versus an estimated $250 billion had Clinton got into office).

In summary

The reality is that we don't yet know the effect Donald Trump will have on the global economy. But if there's one thing markets have shown us, it's that there is no need to panic. His policies breed both fear and hope, and will likely result in both positive and negative outcomes. But that would be no different to every other US president that has gone before him. In the meantime, fasten your seatbelt. It's going to be one heck of a ride.

First published on 7th February 2017 by Matthew Brittain, Investment Analyst, Sanlam UK.

MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

February saw equity markets continue to climb, new highs being hit on a monotonous basis by the S&P 500. Markets progressed under the shadow of Trump and to a lesser extent Brexit and European elections. Despite the inflammatory unknowns unravelling around us, the VIX (a measure of implied volatility in the S&P 500) began the year securely tethered to levels implying complete apathy to risk, and February only saw this head lower.

The US led the way for major indexes in February, up over 5%, but was followed in hot pursuit by most major markets. The FTSE 100 was up 3.09% (24% for 12 months), Europe was up nearly 2% and emerging markets 4.4%. Despite the equity positivity bond markets were far less synchronised. The 10yr TSY remained relatively flat at 2.36% while the 10yr Gilt yield dropped 26bp to finish the month at 1.15%.

Equally, in Europe, we saw the bund yield contract by 23bp but of more interest was the relative popularity of the German 2yr over the French 2yr bond – the yield differential widening by 20bp as investors gravitated to the relative safety of Germany given the increased credibility of a Le Pen presidential challenge.

Index

	February Return
FTSE World Index	4.02%
FTSE USA TR GBP	5.07%
FTSE Europe ex UK TR GBP	1.86%
FTSE Japan TR GBP	2.53%
FTSE 100	3.09%
FTSE all share	3.11%
FTSE EM	4.40%
FE UK property Proxy TR in GB	0.64%
10yr US TSY	-9bp
10yr UK Gilt	-26.7bp
10Yr Bund	-22.9bp
10yr French	-14.6bp
10yr Italian	-17.4bp
10yr JGB	-4bp
Corporate bond index TR GBP	1.17%
HY bond index TR GBP	1.38%
Global Inflation index TR GBP	1.09%
£/$	-1.58%
£/€	0%
Dollar index	1.6%

*Past performance is not an indication of future returns. The value of investments and any income from them is not guaranteed and can go down as well as up.

United States

Stock markets continue their march upwards while the world watches with a mixture of anticipation and trepidation as to the impact of ensuing policy changes promised by the Trump administration. While approval ratings have fallen further for the commander in chief, business and consumer confidence has taken a dramatic shift upwards. Much of the economic prosperity that has seen expectations for a March rate rise increase from 20% to 69%, was embedded well before Trump's victory, with ISM manufacturing and the Citi Surprise index positive for some time, and unemployment hovering around the theoretical natural rate.

Inflation and growth are also feeding into the economy with Q4 GDP revised to 3.1% and current inflation measures knocking at the 2% level. With Trump's policies in addition to this and FED action also likely, look out for volatility over the coming year as stagnation unravels and previously benign economic inputs spice up expectations.

United Kingdom

Over the month the second estimate of Q4 GDP improved from 0.6% to 0.7% further highlighting the as yet anaemic impact on economic growth from the expected impacts of our future divorce from Europe. What can be seen, however, is the actual impact from the decision, as the subsequent fall in the currency continues to accelerate inflation, CPI coming in at 1.8% in the February report.

While the economy remains robust for now there are certainly risks still to take effect and how business confidence and consumer spending look through the conjecture will largely shape the hand that Carney has to play while managing inflation. Currently, the Gilt markets are not pricing in any central bank action with only a 10% implied probability for a rate rise this year. With inflation accelerating to its highest level in 2 years and drivers imbedded to support this further, dramatic swings in both the fixed income and equity markets are by no means unlikely.

Europe

Last month's jump in inflation for the Eurozone's largest economy to 2.2% provided ballast to the hawks calling for the ECB's ultra-loose monetary policy to be addressed. Rising oil prices and positive economic signals from most of the union imply momentum is building, even if from a low base. With Eurozone manufacturers reporting their best level of activity last month since the depths of the sovereign crisis, the economic signs are encouraging.

Money supply remains accommodative and private loans are strong. Economic sentiment has improved on last year but interestingly remains at sanguine levels, and this leads us seamlessly to the issue of politics. With the current wave of political change spreading to upcoming European elections in Holland, France and Germany, we nervously wait on results given the blindfold created from recent poll success.

Japan

Currency moves were negligible for February, negating an often strong driver for Japanese equities. Despite this, stock markets reacted in tandem with world equities, rising 2.5% over the month. Of interest to investors will be the impact of FED tightening on the Yen and potential trade tariffs with the US. Domestically the BOJ's policy to control the shape of the

yield curve has caused confusion in the bond markets, who are sceptical in their ability to hold the JGB at the stated 0% target rate.

Emerging Markets

Despite concerns over trade wars and tariff's from the Trump twitter account, and the rhetoric around currency manipulation, emerging markets participated in the equity rally we saw across the developed indexes. Further concerns of the impact on budget deficits from impending FED rate rises were also shrugged off. Emerging markets have recovered well since the rebound that began 12 months ago and still offer good value. There is huge variation across the index in what drives growth, but comparatively stable commodity prices and a conservative interest rate programme from the FED (for now), have helped build confidence in emerging market equities. Risks remain as ever, particularly across the Chinese debt spectrum, and from a hawkish change in the US interest rate programme, but equally strong US growth drives emerging market growth as well.

*All performance data quoted in this article is derived from FE Analytics

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