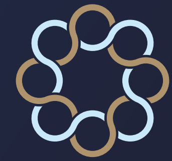

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POINTS OF VIEW

MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

November was a lacklustre month in terms of stock market returns. Japan and The US led the way with rises of 1.14% and 1.06% respectively, which resulted in the FTSE World index managing a rise of just 0.7%. Closer to home the FTSE All Share fell by 1.66%, as did Europe and Emerging markets which fell by 1.50% and 1.68%. However, although returns were small, there were lots of interesting developments as highlighted in the paragraphs below.

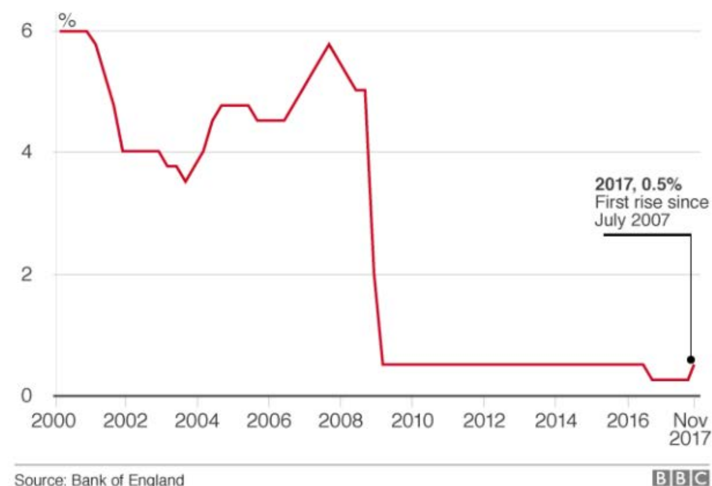
The US

November saw President Trump deliver one of his election promises; tax cuts! Approximately 1.4 trillion of cuts will be made over the 10 years. Corporation tax will be reduced from 35% to 20% hopefully encouraging companies to repatriate cash holdings from overseas. What the effect of such largesse is disagreed. The Republicans state that the tax cuts will unleash growth that will pay for itself. Companies will invest more, growth goes up which will compensate for the loss of tax revenue. Others argue that the growth the US is experiencing at the money should be used to pay down debt (US debt has tripled over the past 10 years).

Meanwhile the outgoing Chair of the Federal Reserve, Janet Yellen was able to pronounce that 3rd quarter growth in the US was a robust 3.3%. The recovery from the financial crisis in 2008 has been the third longest expansion in history. Many are not forecasting a slowdown just yet but with rising interest rates and low unemployment, will wage rises lead to more inflation than expected.

The UK

News outlets have had no problem filling copy given the ups and downs of the Brexit talks. At the time of writing it is close as to whether a deal on the Irish border can be agreed and talks can move on to discuss future trade agreements. Politics is never far from the surface and the turbulence this may cause. Watch sterling as this is probably the first market that will react to progress or otherwise. This can have an effect on the competitiveness of exports and translation of overseas earnings, a significant part of the FTSE100.



Of note during the month was the first interest rate in 10 years from the extremely low level of 0.25%. Any other rises are

likely to be glacial with a forecast rise of 2 more rises over the next 3 years. The budget during the month appears to have passed with no controversies. Consumer spending (a mainstay of the economy) has slowed as inflation (via a lower exchange rate) squeezes incomes. It is hoped that the rise in exports will offset the consumer.

Europe

Post the German election in September it was assumed politics had returned to normal. However talks failed in trying to form a coalition government, suddenly the long-term future of Angela Merkel looks in doubt after 12 years in power. And in Spain, the euros area 4th largest economy, the Catalan crisis is less in the headlines but still rumbles on with leaders of the region facing prosecution. Overall political leadership to tackle some of the deep-seated problems of the region may be delayed. However in spite of the above, economically the region itself continues to set a good pace. Activity indicators in France, Germany the Eurozone are above forecast and are increasing, with both manufacturing and services both expanding. Unemployment dropped to 8.8%, a 9 year low but inflation remains low at 1.5%.

Japan

Japan grew for the seventh consecutive quarter (the longest run in 20 years). The economy benefitted from rising global demand and a weak yen helps exports (think cars and electrical goods) as well as continued financial stimulus from the government, affectionately known as Abenomics. Ending deflation is the goal of the latter, a debilitating condition where consumers hold off purchases as they know goods will be cheaper in the future. Although inflation is now at 0.7%, this still remains below the target of 2%.

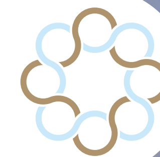
Emerging Markets

Russia and OPEC agreed to extend their oil production cuts to the end of 2018. The oil price is now nearing $60 per barrel, up from a low of $30 in early 2016. It used to be the case that low prices were bad for emerging economies and vice versa, but that relationship is perhaps not as strong as it was. A decade ago energy companies accounted for 15% of emerging market indices, that is now approximately 7%. The IT and electronics companies are now 25% of the indices, think Alibaba, the Chinese technology company. Although many emerging markets are still resource and manufacturing heavy, that is changing as their economies begin to resemble their developing market counterparts i.e. the service sector is growing.

Source: Macrotrends

*Past performance is not an indicator of future returns.

First published on 8th December 2017 by Simon Brett of Parmenion Investment Management.



BUDGET NOVEMBER 2017: THIRD TIME LUCKY?

If the Chancellor suffers from claustrophobia, he'll have been having a hard time of it in recent weeks. Mr Hammond has been hemmed in on one side by sobering economic and fiscal forecasts; on another by public services and national infrastructure showing the strain after seven years of austerity; and on a third by members of his own party, willing him to fail. So when it came to this, his third Budget, how did the Chancellor play his unlucky hand?

Mr Hammond tried to strike a note of economic and fiscal optimism. As expected, the Office for Budget Responsibility (OBR), the Chancellor's independent economic and fiscal arbiter, lowered its estimate for public borrowing in 2017/18 by £8.4 billion, on the basis of stronger-than-expected tax revenues and lower public spending so far this year. The country's debt burden is still expected to start falling next year, allowing Mr Hammond to argue that we have turned the corner on the public finances. He was also keen to highlight the upward trend in employment.

Using what little flexibility he had, the Chancellor portrayed this as a Budget creating "a country fit for the future". The reclassification of housing association debt from the public to the private sector has conveniently allowed Mr Hammond to shift his fiscal goal posts by around £5 billion a year. He also outlined plans to raise additional taxes from the corporate sector, including via indexation freezing, and through the "usual suspect" of clampdowns on tax evasion and avoidance. As a result, he was able to loosen his fiscal stance by £7 billion over the period to 2023 – a little more than expected ahead of his speech.

Some of this additional funding has gone to the National Health Service. Mr Hammond has allocated an extra £3.4 billion over the next three years, presumably hoping to avoid negative headlines over the winter months, and additional capital spending of £4.2 billion out to 2023. But the Chancellor is still intent on meeting his self-imposed fiscal goals, lowering government borrowing to 2% of national income by 2020-21 and eliminating the deficit altogether by the mid-2020s.

But that's where the good economic news ended

The OBR downgraded its outlook for UK GDP growth both in the short and medium term by more than expected. The short-term cuts – to projected growth rates of 1.5% this year and 1.4% next, from 2.0% and 1.6% respectively in the March Budget – are a little below economists' current consensus.

They are also disappointing for a small, open economy that would normally be benefitting from a world economy that is expanding at its fastest sustained pace since the global financial crisis. But it is the long-term downgrades – to growth rates averaging an anaemic 1.3% in 2019 and 2020 and only modestly higher beyond – that are ultimately more damaging to the Chancellor's aspirations.

And Mr Hammond's Brexit-fighting "war chest" has shrunk. The worsening economic news, combined with the fiscal impact of Mr Hammond's U-turn on raising taxes for the self-employed back in March and the £1 billion post-election sweetener for the Democratic Unionist Party, has cut his headroom relative to his own fiscal rules from £26 billion at the time of the previous Budget to £14.3 billion currently. He chose to position this as a positive choice, to help hard-working families and ready the economy for the future. However, it leaves him with a very small margin to play with, given total tax revenues and public spending commitments amounting to hundreds of billions of pounds each year.

The Chancellor attempted to fight back on the OBR's negative productivity message, with some productivity-boosting measures of his own. After all, the only way the UK can hope to escape its current economic challenges is by improving its productivity performance, enabling economic growth and tax revenues to rise faster than the OBR currently expects.

Mr Hammond set out parts of the government's industrial strategy, allocating tens of millions of pounds to skills training and transport infrastructure over the next few years, and hundreds of millions to increasing research and development tax credits. All other measures to create "an economy fit for the future" are, however, dwarfed in terms of funding by the £3 billion to be allocated over the next two years to preparing for EU exit – a concession from Mr Hammond to his pro-Brexit critics.

Housing market in focus

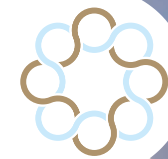
As expected, Mr Hammond also portrayed this as a Budget to tackle the UK's "broken" housing market – and this is also where this Budget's inevitable surprise came from. He repeated his goal of raising housebuilding to 300,000 new homes per year, aided by the commissioning of new building on public land and funding for local authorities. This will go some way – albeit modestly – towards addressing "supply side" problems in the housing market.

But the "demand side" measures announced today, particularly his rabbit-from-the-hat of a stamp duty cut for most first-time buyers, risk adding more to house prices than to addressing issues with the housing stock. Indeed, that's exactly what the OBR is predicting. It believes the stamp duty cut will increase house prices by 0.3%, mainly in 2018, with the biggest gainers, therefore, being people who already own property – not first-time buyers themselves.

So how did he do?

Budgets in the early years of an administration are normally when Chancellors get the "heavy lifting" done – raising taxes or shifting spending priorities in anticipation that this will pay dividends in time for elections up to five years into the future. However, these are not normal times.

Mr Hammond's constraints meant that, despite his best efforts at vision and vigour, this Budget went with more of a whimper than a bang. A bold approach would have been to take housebuilding and infrastructure spending out of



his budgetary rules altogether, arguing that they are too important to be left inside a self-imposed fiscal straitjacket.

Today could have been a golden opportunity to take a distinct, long-term view of the UK's prospects, tackling the country's productivity performance head on. An expanding economy would underpin confidence, spending and tax revenues, ultimately benefitting the public finances.

Instead, the two most notable measures in today's Budget were the £3 billion allocated to Brexit preparations and the stamp duty cut for first-time buyers. The first was directed at Mr Hammond's critics, many within his own party, who would like to see him replaced. The second was intended to provide a boost for young, aspiring house purchasers but may ultimately benefit their middle-aged peers.

Market implications

The Budget is likely to be received calmly within equity, currency and, perhaps most importantly for the Chancellor, debt markets. However, as already noted, it was delivered against a backdrop of a very disappointing UK economic outlook and with considerable uncertainty around the likely implications of Brexit. While Mr Hammond outlined a variety of measures that will affect the corporate sector, this anaemic growth environment is likely to have the greatest impact on companies operating in the UK over the coming years.

The Chancellor announced a raft of initiatives to improve productivity and to enhance the UK's position in the technology and digital economy, the most material of these being the increase in the R&D expenditure credit to 12%. Time will tell as to the efficacy of these initiatives, but they will broadly be welcomed by the business sector.

Corporation tax rates were left unchanged, remaining competitive with our global peers. However, several initiatives, such as the freezing of the indexation allowance and the application of income tax to royalties relating to UK sales, will result in companies experiencing a tax increase.

The measures on the housing market were well-trailed overall and were broadly in line with investors' expectations. However, the Chancellor is obviously losing patience with what he sees as the large housebuilders' inefficient use of their land banks.

His announcement of an "urgent review" into the "significant gap between the number of planning permissions granted and the number of homes built" reflects this impatience, with housebuilders' shares weakening on the announcement. The supportive comments on the purpose-built private rented sector will be welcomed by institutions eager to participate further in this area.

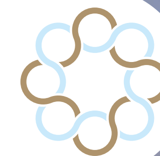
Stability for pension and savings

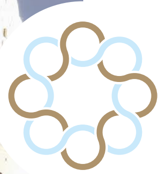
Mr Hammond made few changes to the UK savings market. This will be welcomed by an industry that had called for stability in pensions and investments policy following some fairly significant changes over the past few years.

As a follow-up to the Treasury's recent Patient Capital Review, the Chancellor announced a £20 billion action plan to unlock new investment in UK "scale-up" businesses. Alongside this will be a new fund through the British Business Bank, seeded with £2.5 billion of public money. The Chancellor also made reference to "facilitating pension fund access to long-term investments". All these measures will be welcomed and may allow the further closing of the financing gap at the smaller end of the private equity market.

The Chancellor's statement did not move markets significantly, an outcome that he is likely to be happy with. It was also a statement delivered in the context of a global economy that, while growing at a healthy pace, may be seeing the liquidity tide of low-interest rates and quantitative easing starting to ebb. The outcomes of events beyond our shores are, therefore, once again, likely to have more influence on UK markets, in all their forms, than the Chancellor's pronouncements from the dispatch box this afternoon.

First published on 24th November 2017 by Lucy O'Carroll, Chief Economist, Aberdeen Asset Management.





CENTRAL BANKS STILL SPOOKED BY THE GHOSTS OF THE PAST

The recent increase in interest rates announced by the Bank of England leaves us with no more clarity about the direction of monetary policy than we had before the micro-adjustment. Indeed, the increase raises rather more questions than it resolves.

Ostensibly, the 0.25% move simply reverses the rather ill-judged post referendum cut. However, we have no clear understanding of whether we are at the start of a sequence that will see regular increases in rates along a path towards normalisation or, alternatively, whether this move was simply a nod to those worried about inflation becoming more embedded. If the former, how will the sequence emerge; if the latter, to what extent will the Monetary Policy Committee's (MPC) nerve be tested by future trends in consumer prices?

The real question relates to the collective mood of the MPC. In the United States, it would seem that there has been a swing in sentiment about the Federal Reserve. Following the first rate rise there – in November 2016 – the Fed published projections showing that the intent was to edge up rates very gradually over the forthcoming few years. Nonetheless, it was still rather more focused on the risks rather than the rewards of normalisation.

As a result, it continued to look for excuses to temper the pace of the tightening. Earlier this year there was a distinct mood change, and it would seem the Fed is now looking for reasons why it should not continue along the rate path it has projected. That is not to say that attitudes could not change again. However, it would appear that the Fed has become more confident in taking rates towards more normal levels it will not bring the economy to a juddering halt.

It seems unlikely that the MPC has yet reached its moment of Nirvana – or that it will reach it anytime soon. With some justification, it can claim that the position of the UK has been made more complex by the decision to leave the EU and the consequent increase in economic uncertainty. So, although the Bank's inflation forecasts imply that rates will have to rise if the inflation target is to be met by the end of the forecast period, the MPC is unlikely to feel under undue pressure to ensure this through pre-emptive rate increases. In other words, when assessing the balance of policy, the MPC is still likely to regard the possible economic risks of higher rates as outweighing the potential rewards.

In public, we often see and hear the guardians of monetary policy congratulating themselves for taking the aggressive actions that helped the economy avoid the implosion that could have resulted from the financial crisis. In its more private moments, however, the committee must reflect on the fact that it presided over the policy environment that not just tolerated, but actively encouraged, the ruinous build up of debt that in large part caused the crisis. Economic historians will not be as reverential towards our policy makers as many commentators are today. But with that historical background, it is impossible for the MPC to make untainted policy decisions

today. The MPC may be independent of government, but it is not independent of its history.

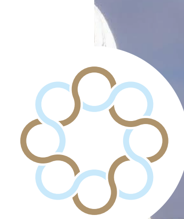
I think it is now clear that an extended period of unconventional monetary policy has not fostered the economic momentum that was envisaged. Economists at the Bank, defending the course that it has taken, constantly broach the so-called 'counterfactual'. In other words, critics of policy should cease their reproaches, because they do not know how bad things could have been, had the current policy regime not been adopted. This, of course, is true of anything, at any time. Moreover, the counterfactual itself has no bias. While we may not know how bad things might have been, we also do not know how much better things could have been.

In my view, the extended period of low rates has reduced economic challenge and induced economic laziness. Nowhere is this more evident than in the very low rates of productivity growth that have been evident in all major advanced economies since the great recession.

It is productivity growth that generates real wage increases and real profits growth. But negative real returns from cash and government bonds have created the lopsided position in which companies no longer have to compete for capital, so there is no pressure to take the risks involved in embarking on potentially productivity-enhancing capital investment. And investors are kept happy by cash-flow being pumped into dividends.

So, while UK policy makers continue to allow themselves to be haunted by the consequences of past policy mistakes, the US Fed seems to have adopted a more forward looking approach. If the reward is that productivity and growth momentum improve in the US as interest rates rise, other central banks may be jolted out of their policy comas.

First published on 20th November by Richard Jeffrey, Chief Economist, at Cazenove Capital Management.



2017: THE YEAR THAT GLOBAL ECONOMIC GROWTH PUSHED ASIDE POLITICAL POSTURING

As publicly traded companies announce strong earnings growth for the last three months, markets have had a relatively muted reaction, meaning good results were expected. As the global economy heads into 2018 on a reasonably sure footing, it's tough to keep perspective when things are looking so positive.

Perhaps the biggest surprise of 2017 was that there were very few market surprises at all. While the political environment was anything but stable, financial markets experienced sanguine conditions, allowing valuations to grind higher while volatility remained extremely low.

This is largely thanks to the acceleration of economic growth across all key global markets – especially Europe, China and, to a lesser extent, the US. Against this backdrop, nothing was able to divert equity markets from the positive growth story. Indeed, it has been 18 months since there was a 5% equity sell-off, 23 months since there was a 10% correction, and we're now heading into our ninth year of this bull market. Leading indicators suggest this positive momentum will continue into 2018 (see page 2), with particularly strong performance predicted in Europe and emerging markets.

Europe on the march

Europe was one of 2017's big surprises. At the start of the year, investors were nervous about the rise of populism. But as Germany, France and Belgium went to the polls, their fears proved largely unfounded, and it ended up being one of the best places to invest this year. European equities have returned 18% year to date, versus 11% returned by global equities. As the graph below shows, this outperformance has arisen since the French election in April.

Source: Bloomberg

US investors bank on tax cuts

In the US, the Senate has passed Donald Trump's corporate tax cuts voting 51 to 49 to support what is the largest single change to US tax since the 1980s. It will see the corporate tax rate slashed from 35% to around 20% and Republicans hope it will support the US' already growing economy. Companies that earn most of their revenue in the US have seen their share prices jump since the vote in anticipation that some of these cuts will filter through to shareholders. The vote is not only a victory for Trump, but may also provide an additional boost to the global economy.

China takes stock, while the UK deals with Brexit

Meanwhile, after delivering an exceptional year, the growth outlook in China has deteriorated moderately (although we

still expect it to be high) and, according to the recent Budget, growth in the UK will remain subdued for at least the next couple of years until perhaps the early 2020s.

Making the most of the global opportunity

But that's the beauty of being global investors. It comes down to trying to access the very best opportunities the world has to offer. Our positioning in Asian equities and corporate credit has allowed us to deliver a great client outcome this year, while adequately protecting them from the risks that might have been…

"As economic conditions have improved, markets have moved higher to reflect the favourable outlook. We expect this to continue, but we're mindful that there seems to be little margin of safety in prices should conditions deteriorate, as inevitably they will – eventually." - Philip Smeaton, Chief Investment Officer.

Market confidence ends 2017 on a high

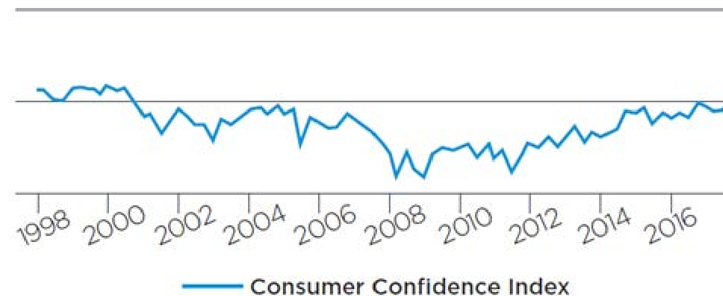
Manufacturing

The Purchasing Managers' Index, an indicator of the economic health of the manufacturing sector, continues to improve across key markets. Even in the UK, where Brexit has undoubtedly stifled business, manufacturing has benefited from a weak pound.

Country	Dec '16	Nov '17	Change
US	54.5	58.7	▲7.7%
UK	55.8	56.3	▲0.9%
Germany	55.6	60.6	▲8.9%
Brazil	45.2	51.2	▲13.3%
China	51.4	51.6	▲0.4%

Consumer Confidence

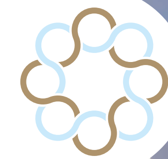
Consumer confidence levels are at their highest since 2001. Retail sales are good – especially for online retailers.

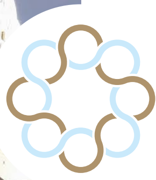


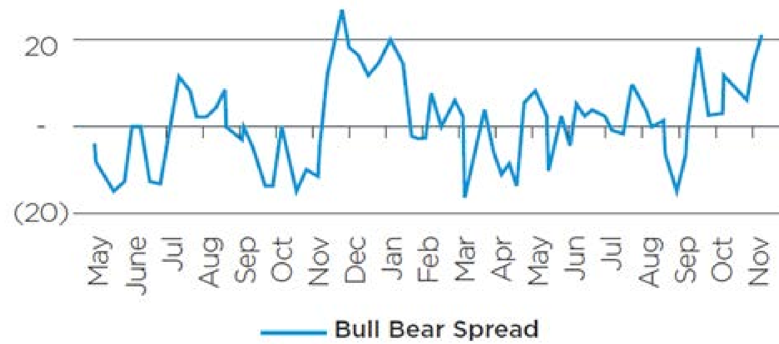
Source: Bloomberg

Investors are bullish

According to a poll that measures investors' attitude to market outlook, confidence levels have climbed back to the highs they hit a year ago.







Source: Longleaf Capital

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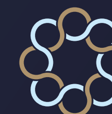

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