Economic Commentary – September 2017

Overview

Global equities have performed well in the year to date fuelled by synchronised global economic growth and comparatively strong earnings data. This has offset the political risks created by various elections and provocative rhetoric from North Korea. The FTSE World index has gained 7.98% to the end of September. The FTSE 100 started the year at 7,142 and is now at 7,458 having finished August at 7,438.
We remain cautious though. In our view, equity and bond markets are overvalued and face a number of risks. At the macro level risks comprise debt levels in the developed economies and tightening monetary policy. We are also concerned about the influence of passive investment vehicles on equity markets and the inter-related issue of a concentrated number of large stocks leading the market, especially in the US.

Monetary Policy

Following unprecedented levels of quantitative easing (QE) in the last 10 years, the Federal Reserve, European Central Bank, Bank of England and Bank of Japan hold $14 trillion of securities, of which just under $10 trillion comprises conventional government bonds. Before the financial crisis only the Federal Reserve and Bank of Japan held any government debt, totalling just over $1 trillion of bonds.
The long upward march of equity market in the last few years indicates the effects of QE have been significant albeit difficult to precisely quantify. It is also clear that cheap borrowing, ample dividends and frequent share buybacks facilitated by low interest rates have given impetus to equity markets. Tighter monetary policy could gradually change the direction of travel for markets.

The Federal Reserve will begin to reduce its holdings of government debt in October, signalling its confidence in the economy. The Fed will reduce its $4.5 trillion balance sheet in small incremental steps, by no longer reinvesting maturing securities. Interest rates are likely to remain comparatively low. The Fed's long-term "neutral interest rate" is now 2.8% from 3.0%. The trend in the last 30 years has been downwards, due in part to ever increasing levels of government debt. Interest rates were 7.25% in 1987, 5.5% in 1997 and 4.5% in 2007.

The Bank of England gave a strong signal at its September meeting that UK interest rates could increase in the next few months. President Draghi of the European Central Bank has signalled that in the coming months the council will "calibrate" the current QE programme of €60bn in asset purchases per month when it expires in December. We expect European QE to continue next year but at a lower level.

Oblivious to the lesson from other economies such as the US and UK, where QE only inflated asset prices and did not feed through into the real economy, the Bank of Japan has recently indicated it will continue its powerful monetary easing until a 2% inflation rate is achieved.

Share Price Dispersion and the Influence of Passive Investment Strategies

After a decade of comparatively benign market conditions and low volatility due to the safety net provided by QE "irrational exuberance" may, once again, be driving equity markets onwards. This time around participants are not concentrating on a specific sector such as technology or housing. Instead there is

crowding into passive investment products, in particular exchange traded funds, which are perceived by some as a cheap and effective way to access equity markets. Large scale flows into exchange traded funds (ETFs), especially in the United States, indicate faith in the equity market as a whole. According to Deutsche Bank, around $800 billion was invested in ETFs globally in 2008; the figure is now £4 trillion; £3 trillion of which is held in US-based ETFs.
Most passive investments simply try to track a particular index and are weighted towards the largest, most highly valued stocks. The more money flows into passives, the more demand there is for these stocks and the more their prices are pushed up, perpetuating their overvaluation.

The influence of passive investments is a plausible explanation for the dispersion in share prices seen in equity markets, in particular in the United States. For instance, Bloomberg recently reported that over a third of the rise in US equities this year is due to the performance of half a dozen technology stocks including Microsoft, Facebook, Apple and Amazon. Passive investing is insensitive to individual equity valuations, so to a certain extent, the normal price discovery mechanism is being bypassed and valuation risks are the end result.

Our Strategy

We define risk in terms of the potential for capital loss. Although equity markets are currently overvalued, we consider bonds to be overvalued to a greater degree, although there has been some price correction in the last year with the FTSE Actuaries UK Conventional Gilts All Stocks index losing 3.6%.

We aim to mitigate risk within the equity portion of portfolios, relative to the broader market, by focusing on funds which invest in good quality companies. The underlying holdings of these funds have various features which can help to mitigate risks. Strong, reliable cash flows, significantly in excess of the operational needs of the company enable them to navigate difficult conditions and to maintain their dividends. The funds also tend to be tilted towards multinational companies with revenue streams from a number of countries. This can help to offset foreign exchange swings, the business cycle of specific economies, or some unexpected macroeconomic or political event in a particular country.

We continue to advocate holding a cash buffer as “dry powder” to be deployed when markets come to more reasonable valuations. What you pay for an asset is a crucial component of long term performance.

US

Forecasts for economic growth are largely unchanged: 2.4% in 2017 and 2.1% in 2018. Debate around country’s debt ceiling issues has been deferred until December. We have seen plenty of market “noise” over raising the debt ceiling in the past few years, in part due to increasing polarisation of US politics, but the issue has typically been resolved quickly.

We remain cautious on the outlook for the broad US market based on valuation levels, but recognise there are high quality US companies, with solid long term prospects and secure dividends which are included in our global fund choices. We have been encouraged to see some rotation in fund portfolios this year to take profits from companies which have become especially overvalued and to redeploy them into sectors which might perform well in a rising interest rate environment. This includes some well capitalised financial companies.

UK

We invest with high conviction managers who will not buy stocks which are significantly overvalued. Active managers can experience periods of short term underperformance and volatility. We avoid knee-jerk reactions to this and engage with the fund managers to retain perspective.

In the 12 months to 30 September 2017 some of our core UK Equity Income fund choices have had relatively disappointing performance in comparison to the FTSE All-Share. In part this has been driven by the fund managers' avoidance of certain sectors such as mining, which has gained 34% in the last twelve months. On a longer term view the mining sector gained just 9% in the last 5 years due to a decline of 41.7% in 2014. In comparison, the pharmaceutical and tobacco sectors, featured prominently in our preferred funds in this time period, gained 65% and 77% respectively, helping to drive long term relative outperformance for the funds.

In addition to sector positioning, profit warnings from holdings in some, but not all, of our fund choices have also negatively influenced performance in the last few months. We carefully monitor the holdings of our fund choices to ensure diversification. Muted performance from some funds has been offset to a degree by solid performance from other funds which do not include these companies, highlighting the importance of variation in portfolio holdings.

Provident Financial is held by 3 of our preferred funds. The company announced profit warnings in both June and August 2017. Mismanaged changes to IT and operations have impaired credit collections and agreement of new loans. The company is also subject to an FCA investigation regarding a flexible repayment product. The company may be fined for this but will hopefully not face mis-selling claims from customers because the product was clearly explained to them in writing, in contrast to the scandal involving PPI which embroiled all of the leading banks in the UK.

We have already had a conference call with one of the managers who invest in Provident Financial. He was able to discuss the company's turnaround plans in detail having met with the company's management that morning. In his assessment, it will take time for the company to recover but it has the potential to do so. Provident are the largest player in the fragmented home loan collection market and have a number of other business units which remain profitable.

We have calls and meetings scheduled in the coming weeks with the other managers. One of the managers had already been taking profits in the holding in Provident since 2015 to lock in capital gains. This also limited the impact of the recent fall in share price. Dividend distributions from the company had already more than covered the initial purchase price, so in no sense has an absolute loss been made from the holding within this fund.

Europe

There are continuing signs of economic recovery, both in Northern Europe and also in previous laggards such as France and Italy.

Political events such as the German election and the controversial Catalonian independence election have a short-term impact on equity markets, but it is the strengthening of the Euro which has had the most impact for Sterling-based investors in the year to date, enhancing returns.

We continue to focus on funds investing in quality businesses at reasonable valuations, some of which are outside of the Eurozone. There is also a tilt towards either multinationals with diversified geographical revenues and mid-sized companies which have a niche in a particular product or service and recurring revenues which can mitigate the impact of politics and any macroeconomic hiccups.

Asia Pacific and Emerging Markets

Economic activity has accelerated in Japan, with GDP growing by an annualised rate of 2.5% in the second quarter. Japanese equity markets have performed well in the year to date, especially in local currency terms, but we remain circumspect. This is because the Japanese Central Bank owns 40% of a key Japanese stock market ETF and we consider their QE operations to be artificially inflating the market.

The Chinese government injected $1 trillion into the economy to engineer a pickup in economic activity. Now the authorities are once again looking to reign in the estimated $40 trillion in assets held against just $2 trillion in equity within the Chinese banking system by clamping down on mortgage lending. Official communications are putting more emphasis on economic and political stability than growth in the lead up to the 19th Party Congress in November 2017. We remain cautious on the outlook for China and given the size of its economy and influence, this has implications for the entire region.

We retain our negative view of emerging markets, primarily because of the distortions created by large flows to ETFs in the region which invest indiscriminately in state-owned enterprises which can be politically driven and which pay no attention to company prospects and valuations.

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