Weekly Digest

28 January 2019

Investec Wealth & Investment

The weekly insight into world stock markets

# Rate of Change

My first task every week so far this year has been to provide the obligatory Brexit update. Unfortunately the timing of various votes and discussions has meant that we are always a day away from gaining greater clarity on the outcome (or at least the process), and this week is no exception, with various amendments due to be voted on tomorrow. What is noteworthy, though, is the persistent edging away from the possibility of a potentially (economically) damaging "No Deal" Brexit, and the pound remains the key barometer of sentiment in that regard. Since this time last week it has risen just over 2% against other major currencies. This is a mixed blessing for sterling-denominated portfolios, as it depresses the translation of overseas profits (and dividends) generated by multinational companies back into pounds, as well as the value of non-UK investments. Thus we tend to see the FTSE 100 Index (75% non-sterling revenue exposure) underperforming global markets when the pound rises (and vice versa). There is a more limited effect on smaller companies, which, on average, have more domestic UK exposure. Indeed, if the uncertainty is resolved, it could unleash pent-up domestic demand and a potential further rise in sterling would be helpful in reducing costs.

More generally, though, investor sentiment remains poor, with many indicators compiled by various investment banks suggesting that markets are now in panic/bearish mode. This is in stark contrast to the situation twelve months ago, when euphoria prevailed. However, we entered 2018 in a more cautious mood. This was partially based on our reading of the geopolitical and monetary tea-leaves, but also on a view that it was going to be difficult for things to get much better. We were looking at synchronized global growth for the first time in almost a decade, President Trump had just lavished huge tax cuts on the US economy, and markets had been displaying record low levels of volatility.

It is a peculiarity of financial markets that they can perform poorly even when, on the face of it, the underlying performance of companies and the economy is decent. That is because investors tend to focus on the "rate of change" (or, more scientifically, the "second derivative"). Simply put, if something is growing but not as fast as it used to be, that is deemed to be bad news. Thankfully this phenomenon also works the other way, so markets can go up even when the actual news is apocalyptic (as long as the pace of deterioration is fading). These "rules" work even better when looking at annualised figures. Let's look at a few examples of where we are now, which might give us cause for some optimism (or should I say less pessimism?).

One of the biggest influences on financial assets over recent years has been the use of Quantitative Easing (QE) by central banks, with the excess liquidity created finding its way into bond, share and property markets in search of a more generous return. At the start of 2018, global QE was running at an annualised rate of $2.6 trillion. Bank of America Merrill Lynch calculates that by March this year we will be faced with annualised Quantitative Tightening of $400 billion. That represents a huge $3 trillion swing in the amount of liquidity being provided to the market, the equivalent of slamming on the brakes and deploying a parachute. The better news is that this is about as bad as things will get. In fact, they could get materially better, because some commentators are now openly discussing the potential for the Federal Reserve to pause its QT and for the European Central Bank to start QE again (having stopped in December), although this is not in our forecasts.

Similar trends are seen in other monetary data. The global money supply was growing 20% a year twelve months ago; now it is falling a couple of percent. China's unregulated "shadow banking" sector was growing its lending by 20% pa a year ago; now it is shrinking almost 10% thanks to a government crackdown. But on a year-on-year basis, the rate of decline is going to start looking better.

This is not just a monetary phenomenon. Combined with the interventions of Donald Trump, Brexit, etc, it has produce a sharp deceleration in global growth prospects. Citigroup's Economic Surprise Indices illustrate the point. The global series has fallen from +33 to -20. The index for Europe has collapsed from +60 to -88 (it can't go lower than -100). Many people are extrapolating the woe of Germany's economy, but that has been hit by two specific drags: tighter emissions regulations (that have reduced car production) and low water levels in the Rhine (reducing transport). These are expected to normalise in 2019 (and certainly not to deteriorate further).

Company earnings have also been affected. Another Citigroup index for Global Corporate Earnings Revisions has dropped from +40% to -50% over the last year (so a lot more downgrades now than upgrades), taking it back down to levels last seen during the financial crisis. Yes, the quantum of downgrades was bigger then, but we are not forecasting a global recession now (let alone a crisis). Overall, corporate earnings are expected to grow a little this year, down from expectations of 10% growth just three months ago.

I could make a similar case for future expectations for interest rates, bond yields, potential fiscal stimulus versus austerity (outside the US, where Trump has already shot his bolt) or the potential for Trump interventionism (he's already stuck all his fingers into most pies). This all suggests there is a lot of bad news discounted. That's not the same as predicting nothing but blue skies ahead, but now is not the time to hit the panic button.

**John Wyn-Evans**
Head of Investment Strategy

## FTSE 100 Weekly Winners

| | |
|---|---|
| easyJet | 10.3% |
| Just Eat | 8.3% |
| Ocado Group | 7.2% |
| Fresnillo | 6.7% |
| Anglo American | 2.4% |
| TUI | 2.2% |
| International Consolidated Airlines Group | 2.2% |

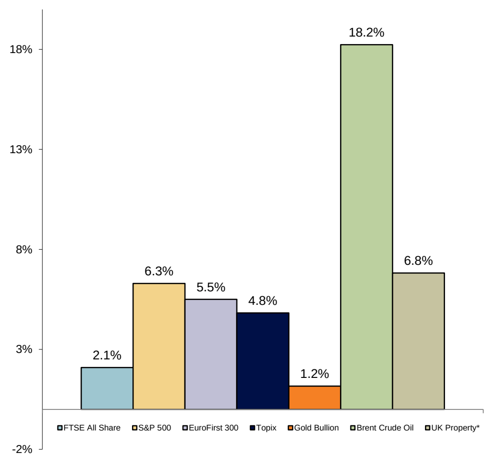
Source: FactSet

## FTSE 100 Weekly Losers

| | |
|---|---|
| GVC Holdings | -8.7% |
| Vodafone Group | -8.3% |
| Rentokil Initial | -6.1% |
| British American Tobacco | -5.9% |
| Royal Dutch Shell | -5.0% |
| DS Smith | -5.0% |
| Reckitt Benckiser Group | -4.7% |

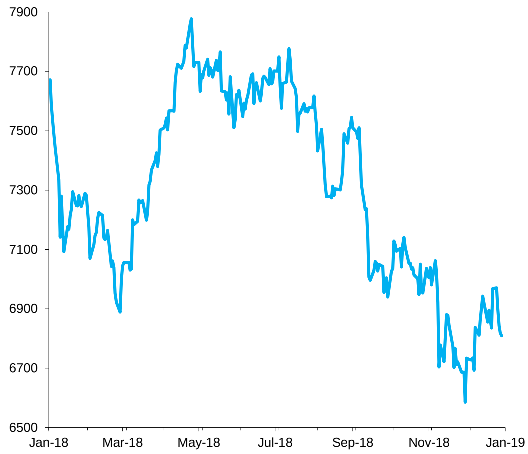
Source: FactSet

## Year to Date Market Performance




Source: FactSet
*IPD Total Return to October 2018

## FTSE 100 Index, Past 12 Months




Source: FactSet



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