Weekly Digest
11 December 2017
The weekly insight into world stock markets

Investec
Wealth & Investment

Edging Towards The Door

Last week our two main strategy committees convened. These are the Global Investment Strategy Group (GISG) and the Asset Allocation Committee (AAC). The first, a joint venture with our colleagues in South Africa, sets the risk budget for the firm. The second decides how to deploy that in portfolios amongst the various asset classes. In this context our risk budget is a measure of how much risk we suggest that investment managers take relative to the benchmark.

All clients' risk appetite is established before portfolios are constructed, and equity equivalent risk across portfolios can range from 30% in a low-risk portfolio to 90% at the high-risk end of the scale. GISG's current score of -0.5 points (the available voting range is +3/-3) is equivalent to an equity underweight of 2.5%. This means that a high risk portfolio could still have 87.5% in equities, which might not look conservative to the untrained eye. It all hinges on the individual's resilience to volatility, which will be dependent upon personal circumstances and the investment time horizon amongst other factors.

So why the caution? In recent Weekly Digests I have written about the possibility that we are nearing the end of this market cycle. The title this week refers to the impending end of a party or concert when we know that everyone will head for the exit simultaneously. We are prepared to leave a few minutes early to guarantee a safe departure and not get caught in the rush. Of course, we also know that this can mean missing one or more encores, but it's been great fun so far, so why spoil it? There are two main reasons for concern. The first is the potential for a surprise rise in inflation next year, especially in the US. Inflation has remained extremely subdued this year. The forecast rate of US inflation five years ahead in five years' time at the start of 2017 (so in 2027) peaked at 2.6%. After hitting a low of 2.12% in June, it has been very steady around 2.3% since the summer. There are two opposing camps on inflation. The "hawks" believe that it is just sleeping, having been kept low by a series of cyclical shocks. These started with the financial crisis, and continued through, for example, the euro zone crisis and the commodity collapse. Most recently it has been driven in the US by a one-off drop in the pricing of mobile phone contracts. However, despite unemployment being at levels normally associated with wage inflation, soon to be followed by price inflation, there is no real sign of this happening. This strengthens the hands of the "doves", who believe that deflationary technological and demographic trends are dominant. They are very much in the "lower for longer" camp, referring to both inflation and interest rates. Current bond yield trends suggest that it's the doves who are winning, so the risk to investors is if inflation does surprise to the upside. That would probably lead to higher interest rates, higher bond yields and lower liquidity, all of which would put stress on financial assets.

The second concern is that any spike in volatility would cause market disruption. According to data from Empirical Research, realised volatility for large-capitalisation US equities is in the bottom 2.5% of a ninety-year range. That basically means that shares are as stable as they have ever been, and stability has a habit of encouraging complacency. Investors take on more and more risk in pursuit of returns. Once risk becomes more evident again, bets are swiftly removed from the table, which further increases volatility and forces more people to withdraw from the market. Markets can suddenly start falling precipitously. The metaphor I have used in the past is that shares go up on the escalator, but go down in the lift.

GISG has an eighteen month investment horizon, and we aspire to be substantially underweight equity risk when the trouble really hits. It is as well to flag this in advance and also to give investment managers and clients time to act, but last week's shift is not a forecast of imminent stress. Indeed, the AAC decided not to implement GISG's change of risk appetite immediately (which, I might add, it is allowed to do!). Balancing the long-term concerns is strong current momentum. The global economy is growing as well as it has done this decade, and, importantly, in a coordinated manner. Corporate earnings are growing around 10% at a global level. Also, there are limited signs of the sort of euphoria associated with a market peak. Yes, global equities keep making new highs, but it has been a grind not a spike and started from the pits of the financial crisis. Merger and acquisition activity, another traditional signal of overconfidence, also remains subdued. At the market peak in 2000, global M&A was running at around 11% of global equity market capitalisation. In 2008 it was about 8%. Currently it is running at more like 3%.

This might all sound a bit like having our cake and eating it. We have sounded a note of caution but not acted on it. That is testament to the difficulties of calling a market turn. We generally counsel "time in the market, not timing the market", but we also recognise that there is value to be added at these turning points. We also get the feeling from a lot of clients that they would happily lock in some of the gains that have been made in recent years at the expense of missing out on a bit more upside. It very much looks like 2018 will be another year of trying to judge the trade-off between positive short term momentum and longer-term risks.

Finally, Southampton, Bosham in West Sussex and Gainsborough in Lincolnshire all lay claim to being the place where King Canute demonstrated that the tide cannot be repelled. This week, which English football league team is nicknamed the Saddlers?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Whitbread	12.4%
Berkeley Group Holdings	7.7%
Sky	6.8%
Mediclinic International	6.5%
Ashtead Group	6.0%
ConvaTec Group	5.4%
Reckitt Benckiser Group	5.3%

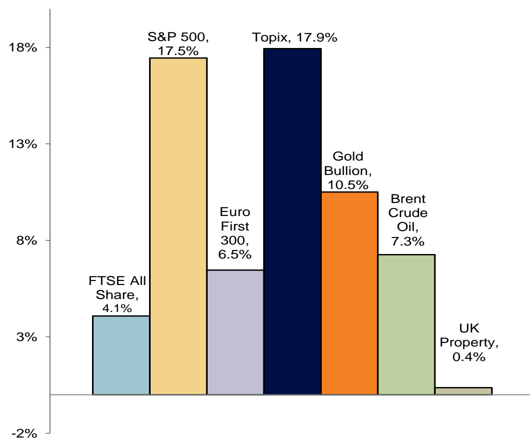
Source: FactSet

FTSE 100 Weekly Losers

Babcock International Group	-4.1%
St. James's Place	-3.3%
Admiral Group	-3.1%
Mondi	-2.6%
Intertek Group	-2.4%
GKN	-1.9%
3i Group	-1.8%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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