Weekly Digest
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The weekly insight into world stock markets

Investec Wealth & Investment

Opportunity Knocks

Last week I observed that balanced portfolios have failed to advance much so far this year, and also that there was little to choose between global equity markets when measured in constant currencies. However, some asset classes have moved quite sharply, and it's worth thinking more about what the implications are for portfolios and whether or not opportunities are knocking to trade against some of the current trends.

The main opportunity I want to address concerns the US dollar and Emerging Markets, two asset classes that are very closely linked. The investment community has developed a Pavlovian response to dollar movements: when it rises, EM assets (currencies, bonds and equities) go down, and vice versa. To make matters worse, EM equities tend to display a positive correlation with their currencies, quite the opposite of the normal experience in Developed Markets. Thus, for example, the FTSE 100 has done very well against a weak pound, whereas broader EM equities have struggled in tandem with the weaker EM Currency Index. This reaction function is deeply rooted in Emerging Market crises of the past, notable examples of which include the Mexican "Tequila Crisis" in 1994, the Asian Crisis (which started in Thailand) in 1997, the Russian Crisis (leading to the melt-down of hedge fund Long-Term Capital Management) in 1998, and also the "Taper Tantrum" of 2013: they were all triggered by rising US interest rates (actual or threatened) and a strengthening dollar.

Of course, there is good reason for this. In aggregate, EM countries are large borrowers of dollar funds. Some of this is driven by justified demand for capital, but it's fair to say that much of it is driven by supply, as investors in developed countries chase higher yields and higher long-term growth prospects. All is well as long as dollar interest rates remain low, but as they rise, so does the cost of servicing the debt, and repayment or refinancing terms become increasingly onerous as dollars become more expensive. In the current episode of weakness, the situation has been exacerbated by several unconnected idiosyncratic problems, including: US sanctions on Russia; economic and political mismanagement in Turkey, Argentina and Venezuela; the threat of protectionism and trade wars. With investors increasingly favouring Exchange Traded Funds to make asset allocations, stronger countries can be dragged down by the weak ones as funds are withdrawn across the board. This is where the opportunities can arise.

We tend not to invest by individual country when it comes to EM exposure, but have a definite preference for Asia relative to South America or Eastern Europe. We prefer the demographic trends, particularly social mobility, and also the healthier fiscal and current account positions. Countries with fiscal and/or trade surpluses will generally fare better during times of stress. Most countries in Asia have been busily building up foreign exchange surpluses since the Asian Crisis, so are in much better shape to withstand short-term headwinds. Furthermore, as we have highlighted in the past, the shift away from dollar currency pegs to floating exchange rates has introduced a safety valve that was not always available in the past. In a pegged environment, the local central bank burnt through currency reserves and raised interest rates through the roof to defend the exchange rate peg. When it (inevitably) broke, the economy had already been decimated by the high interest rates and the collapse in the currency ensured that the dollar liabilities were too big to pay off, creating huge bad debts. At least borrowers now understand that there is a real risk of currency depreciation, so will have been somewhat more prudent in their assumption of foreign exchange liabilities.

The big question now is whether or not the dollar has further to rise. In the short term, momentum is on its side, both in terms of relative economic performance and the actions of its central bank. However, if, as we suspect, the first quarter lull in growth elsewhere in the world is a temporary phenomenon, then interest rate expectations will again move in favour of the rest of the world, depressing the dollar. Any progress on averting trade wars could also be beneficial for the Emerging Economies, which tend to be more exposed to global trade than the US. Maybe it's too early to move aggressively on this trade, but we should at least be thinking about it now. There are other issues which are unsettling investors that could also provide opportunities. There is the strong oil price, which is nudging up inflation expectations and acting as a de facto tax on consumers. The squeeze has been exacerbated by the re-imposition of sanctions on Iran as well as the situation in Venezuela, and the general unease in the Middle East demands a bigger risk premium. But there remains no shortage of supply from US shale fields, and it was this supply threat that originally inspired OPEC to force the oil price down in an attempt to reassert some control onto the market. Barring a major conflagration in the Middle East, we see limited further upside for oil.

Then there is the political situation in Italy, which is developing even as I write. Superficially it looks threatening, but (bearing in mind the Game Theory approach that I discussed a few weeks ago) the most extreme mooted policies would be suicidal for the economy and therefore not likely to be implemented. Finally, the US 10-year bond yield seems to have established itself over 3% now, which raises questions about the discount rate for risk assets. These are all subjects that will no doubt make further appearances over the weeks ahead – and I mean that most sincerely, folks!

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Paddy Power Betfair	21%
Burberry Group	7.0%
Compass Group	5.5%
Micro Focus International	4.8%
Experian	4.8%
National Grid	4.2%
Taylor Wimpey	4.2%

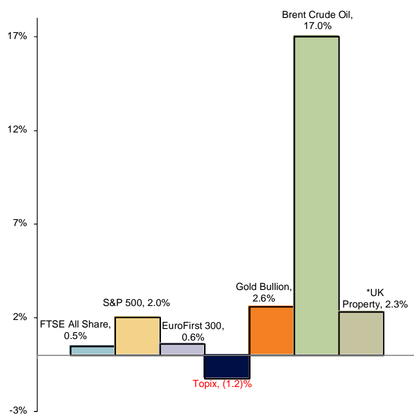
Source: FactSet

FTSE 100 Weekly Losers

Royal Mail	-13.5%
Vodafone Group	-8.1%
BT Group	-6.3%
Old Mutual	-5.3%
Smurfit Kappa Group	-4.6%
Medicinic International	-3.9%
Barclays	-3.2%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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