Weekly Digest
22 January 2018

The weekly insight into world stock markets

Investec
Wealth & Investment

Too Much Of A Good Thing?

For the last two weeks I have bombarded you with numbers concerning stock market performance and valuations. This week, I am going to take a step further back and look at economic statistics. There is broad agreement that global growth is the strongest since 2010 and still accelerating. It also appears to be relatively evenly distributed. There is less consensus about the second order effects of that growth, especially what will happen to inflation, and that will probably be the most important factor for investors.

According to consensus data from Bloomberg, the median forecast for Global GDP growth in 2018 is currently 3.7%, a small tick up from the 3.6% forecast for 2017. The 2018 forecast is up from 3.4% at the start of 2017, and the upgrades really started to come through during the summer. All major economies are feeling the benefit. The US growth forecast has accelerated from 2.3% to 2.6%; Europe from 1.6% to 2.2%; Japan from 1% to 1.3%; China from 6.3% to 6.5%. Only the UK (1.3%), has failed to join the party, although at least the worst fears of a Brexit-related collapse have not been met. So what's going on?

I would contend that there are three major factors behind this uptick in growth. The first, and possibly easiest to see, is the rebound in commodity prices and global trade. Although commodity prices bottomed out as far back as the first quarter of 2016, they really only started to accelerate again in the second half of 2017, driven by a combination of increasing demand and constrained supply. Investment in commodity production capacity collapsed along with prices and just the absence of that negative effect shows through as a recovery in growth. Global trade is closely aligned with the trend of commodity prices.

Second is the passage of time since the Great Financial Crisis (GFC). The further we move away from that event, the more the scars heal, both psychological (investors) and financial (banks). Following the Tech Bust, the GFC and the euro zone crisis, many an investor's mindset had reached the point where "crisis" was becoming "business as usual". The memory of pain is slowly fading. Indeed "FOMO"* is in the ascendant. The wounds of the financial sector have been repaired by surgery. Banks have recapitalised by raising equity and shedding assets, and are now generally profitable and in a better position to lend. Households are also in better health as they have been less dependent upon credit at the same time as household assets (house prices, investments) have risen. (*Fear Of Missing Out)

Finally (and I acknowledge this is not an exhaustive list) China has been a beacon of stability. We thought this would be the case ahead of the Party Congress in October, as the leadership would want to show itself in the best possible light at what is the biggest political event in a five-year cycle. If anything, we were further impressed by China's commitment to maintain stability. Very simply, the country's leaders have an agenda that promises to give it a much bigger role in the world, economically and politically. They know they have a better chance of achieving their ambitions with a more stable economy.

So what's the problem with all this growth? The fear is that too much "boom" will lead to a "bust". Busts don't usually materialise out of thin air. And old market saying has it that economic expansions and bull markets don't die of old age – they are murdered by the Fed(eral Reserve Bank). Indeed, looking at US stock market data going back to the 1920s, we find that only twice have US equities suffered a bear market – a fall of 20% or more – without a recession. These were in 1963, when the main reason seems to have been fear of nuclear war during the Bay of Pigs affair, and in 1987 when the stock market crash was fuelled by the use of "portfolio insurance" products. Slightly worryingly, both of those periods have a possible equivalent today. The tensions on the Korean Peninsula are well documented, although mercifully slightly less worrisome than they have been. Then there is the proliferation of computer-driven trading strategies, "short volatility" products and huge growth in Exchange Traded Funds to contend with. Quite how these will act during a period of greater market stress is the subject of some debate, but there is a definitely a concern that they will exacerbate any downward momentum.

But the main focus for any murder enquiry will have to be the central banks. They have the power to raise the cost of funds and to withdraw liquidity from the market. The main reason for taking this action will be if they detect an overheating of the economy – something that will become visible in wage and (ultimately) consumer price inflation. This is where the economics community fails to find a consensus. Inflation has been notable by its absence in recent years (with the standout exception of the UK, where sterling's devaluation has led to sharp price rises). Economists are split into two camps. The INflationists believe that it is only a matter of time before the historical relationship between monetary growth, economic growth, wages and inflation reasserts itself. They believe that the post-GFC period of stagnant growth is purely cyclical. On the other side are the DEflationists, who believe that ageing, shrinking populations and the implacable march of technology will continue to dampen wage and price pressures. We remain agnostic. Being wed to one philosophy can be very painful if it turns out to be the wrong one. We, like central banks, will have to judge the data as it develops. Finally, in Scooby-Doo, Shaggy's real first name is Norville. This week, in which year did Frank Sinatra have a UK number 1 with Strangers in the Night?

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Head of Investment Strategy

FTSE 100 Weekly Winners

Hargreaves Lansdown	6.3%
NMC Health	5.7%
Evraz	4.7%
GKN	4.6%
Old Mutual	3.8%
Rolls-Royce Holdings	3.7%
easyJet	3.6%

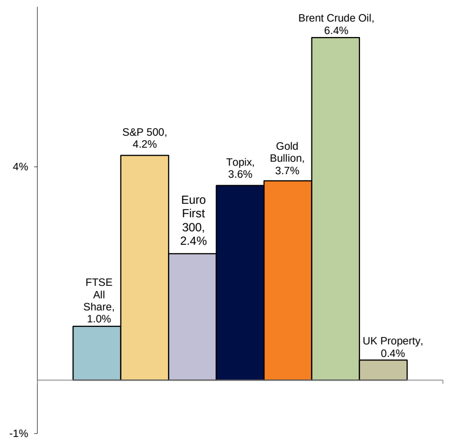
Source: FactSet

FTSE 100 Weekly Losers

Burberry Group	-10.9%
Informa	-6.0%
Micro Focus International	-5.4%
Pearson	-4.8%
BP	-4.7%
Imperial Brands	-4.6%
BT Group	-3.9%

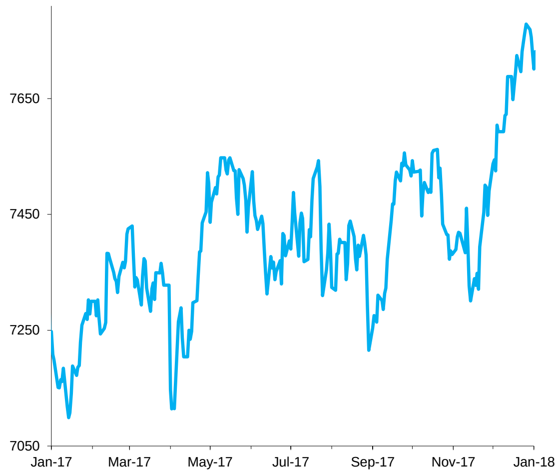
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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