Weekly Digest
23 April 2018

The weekly insight into world stock markets

“This Time Next Year (Rodney), We’ll Be Millionaires!”

Last week I wrote about long-term returns, referring to information from the latest Barclays Equity Gilt Study. All the data I cited was “real”, therefore taking into account inflation. I think I failed to highlight just what a strong (negative) compounding effect inflation can have over such a long period (1899 – 2017). As I mentioned, £100 invested in UK equities in 1899 would have turned into £34,758 in real terms today. In nominal terms, that would be a much more sensational £2,976,377. Put another way, a pound from 1899 is only worth 1.17 pence today!

Not surprisingly, we take inflation very seriously, as should all investors. There is a well-known economic trap that many people fall into called “Money Illusion” - the belief that money has a fixed value in terms of its purchasing power. According to Bank of England inflation data, my dreams of being a millionaire when I started working in the City in 1984 would have to be recalibrated to more like £3 million for today’s graduates. I note the return of the quiz show “Who Wants To Be A Millionaire?”, now to be hosted by Jeremy Clarkson. To reflect fully the effects of inflation since its original launch in September 1998 it should be called “Who Wants to Win £589,909 in Real Terms?” Not so catchy, eh?

If we really want to rub in the loss of value – and invoke one of the great angst-creating topics of the day – what would that million pound prize buy you in the housing market now? In 1998, the average UK house price was £72,500, and it is now £225,000, so more than trebling over the period. It’s even worse in London, where the average has gone from £105,000 to £472,000. Just to complete the picture, average earnings (wages) in the UK have risen by 80%, so marginally faster than inflation (69%), but far slower than house prices, which have been driven by low interest rates and a lack of supply. Is it any wonder that “getting on the housing ladder” is so hard?

A key feature of the post-financial crisis period has been highly unconventional monetary policy which drove interest rates to effectively zero, generally well below the rate of inflation. Bond yields were also dragged lower by central bank purchases (Quantitative Easing), leaving investors reaching for riskier assets to fulfil income requirements. This spawned the acronym “TINA” – “There Is No Alternative” [to buying equities]. Equity valuations were also boosted by the falling discount rate (bond yield), so the fact that interest rates, bond yields and the discount rate are already heading higher in the United States and potentially so in UK, with Europe somewhere behind, sets up a double headwind for riskier assets. First, the valuation case is less strong; second, the relative attraction of safe cash and bonds increases. To some degree we should welcome this change because it signals that the worst after-effects of the financial crisis are easing; that being the case investors might demand a lower risk premium for holding equities. A stronger economic background is also good for corporate earnings; as long as they grow faster than equities derate, there are further gains to be made. So let’s not get too gloomy. Yes, the acceleration phase of growth that we enjoyed last year seems to have peaked, but, a first-quarter hiccup notwithstanding, global growth appears still to have reasonable momentum.

The big deal that triggered the equity and bond market sell-off in February was the jump in US wage inflation, which appeared to serve notice that cyclical inflation pressures were finally taking hold after a long period of dormancy. There has been little evidence to increase those fears since. Elsewhere, notably in the UK, Europe and Japan, inflation data has undershot expectations. On the other hand, some traditional indicators of inflationary pressure, including certain metals prices and oil, have been very perky recently. However, their rise seems more to do with insufficient supply than too much demand. Aluminium has been boosted by Trump’s sanctions on certain Russian businessmen, while there is speculation that the Saudis, keen to get a good price for the Aramco flotation, are nudging the oil price up. Unless these price moves trigger higher wage demands, of which there is no sign yet, central banks should look through them.

What I have just described are cyclical inflation pressures. But what of the secular trends? One school of thought is that demographic and technology trends will keep inflation low. Ageing populations need to work longer and save more for retirement; even younger employees, faced with lower potential investment returns, are being urged to save more rather than spend. Developments in robotics and artificial intelligence will keep downward pressure on overall wages. Certainly inflation can’t continue on its falling trend of the last thirty-odd years without turning into deflation – and nobody wants that. But at least one of the factors that has driven inflation lower, globalisation, appears to have less impetus, even if it is not yet going into reverse. Some commentators are pointing to a change of policy in China, where sustainable growth and environmental considerations are being given priority over growth at any cost, thus reducing overcapacity in many industries (and with it a surfeit of cheap output). The ultimate end-of-cycle argument is that the world’s huge pile of debt can never be worked down, so will have to be inflated away deliberately.

These are tectonic shifts that could have enormous implications for asset allocation and portfolio construction. Supporters of both sides of the argument are convinced they are right. We believe that markets are less well prepared for an upside inflation surprise, but there is insufficient evidence to bet the house now.

Finally, Sir Paul Smith was the British fashion designer was born in Nottingham in 1946. This week, in which country is Smith Volcano?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Mediclinic International	16.7%
Glencore	10.1%
NMC Health	8.2%
Whitbread	7.6%
Smiths Group	6.8%
CRH	6.5%
Ferguson	6.1%

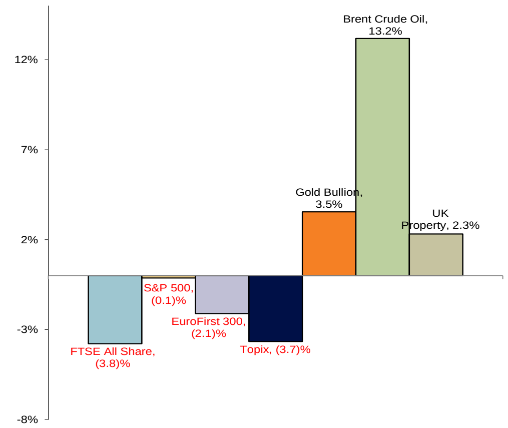
Source: FactSet

FTSE 100 Weekly Losers

British American Tobacco	-10.2%
Reckitt Benckiser	-6.5%
Lloyds	-3.6%
WPP	-3.5%
Imperial Brands	-2.5%
Standard Life Aberdeen	-2.4%
National Grid	-1.6%

Source: FactSet

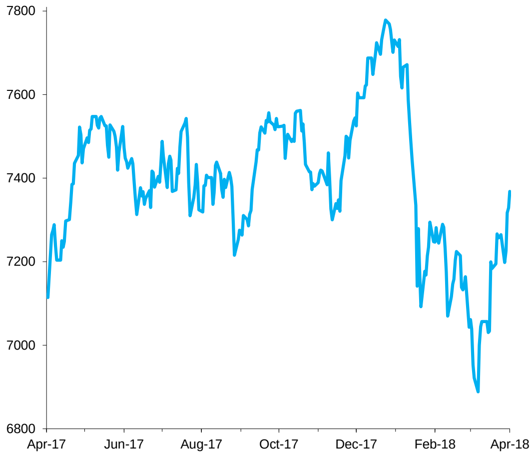
Year to Date Market Performance



*Lagged to latest UK IPD Total Return All Property Index (Mar 2018)

Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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