Weekly Digest

30 October 2017

The weekly insight into world stock markets

Investec
Wealth & Investment

Super Mario Strikes

I have touched on the subject of monetary policy a couple of times in recent weeks. Today I am returning to the topic. In my latest trips to our regional offices to update our investment outlook, I described central bank policy meetings as some of the key "bricks" in the "wall of worry" that equity markets would climb over the rest of the year and into 2018. Other bricks included China's Communist Party Congress (excellently covered by John Haynes last week), various political developments (e.g. the situation in Catalonia and Germany's coalition negotiations), and North Korea. The first of several key central bank meetings came last week, as the European Central Bank (ECB) held its eagerly awaited October meeting.

Central bank meetings are perfect for attracting the attention of traders. The dates are set in stone months in advance; there is a growing expectation of policy shifts; and the decisions have the capacity to catalyse sharp moves in markets. Not surprisingly they generate a huge amount of speculative comment ahead of the event followed by endless post mortems. I suppose I am guilty of adding to that pile!

So why are these meetings currently attracting so much attention? For much of the period since the financial crisis central banks have been in easing mode, either cutting interest rates or implementing asset purchase policies, namely Quantitative Easing (QE). This was done with a view to improving economic growth, which has ultimately been successful (although not everyone agrees on this cause and effect), but has had an even more positive effect on financial assets – fine for the minority of people who own them, but exacerbating inequality and reinforcing the support for populist politicians. Since 2013 there has been a touch more uncertainty. That was when the US Federal Reserve surprised markets by announcing that it would stop its QE programme, triggering the "taper tantrum". Investors have been petrified ever since that another such upset is on the cards, but we have generally avoided a repeat performance for a couple of good reasons. First, investors' positioning in markets is less extreme than it was then; second, the central bankers themselves are aware of the risk of surprising markets again, so have been very circumspect in their announcements, leaning heavily on the concept of "forward guidance".

That doesn't mean that there are no risks. Equity and corporate bond markets came under extreme pressure in early 2016 as investors feared a policy mistake from the Federal Reserve. Its "dot plot" of the future level of interest rates, derived from the forecasts of board members, suggested as many as four quarter percent interest rate rises in 2016. That was in the face of a wobbly Chinese economy and collapsing commodity prices. Obligingly, the Fed held its fire until December 2016, only raising the Fed Funds rate once. There have been two ticks up since, and another is expected in December, but these are against the background of a strengthening global economy. The "dot plot" suggests another three rises in 2018.

At the same time, the Fed has now embarked on the reduction of its balance sheet, thus reversing the previous QE – Quantitative Tightening (QT), if you like. So not only is the cost of money rising, but liquidity is set to decrease, a potentially lethal cocktail for financial assets and, ultimately economies. Time to don the tin helmets? Enter superhero Mario Draghi, president of the ECB. At last week's meeting he did announce a reduction in the level of the ECB's QE, from €60bn to €30bn per month, but extended the programme to September 2018. Furthermore, he suggested that it could be expanded again if required, suggesting that he is in no mood to risk any financial market or economic dislocation. The message was also that interest rates, currently -0.4%, will not rise until at least 2019. So the ECB keeps giving even if the Fed is taking away. Meanwhile the Bank of England is in miser mode, with QE suspended currently (but not being reversed), and a quarter point base rate rise expected on Thursday. The other big active central bank, the Bank of Japan, is committed to keeping Japan's ten-year bond yield close to zero, and effectively has a bottomless bit of ammunition to achieve that aim. This policy was buttressed by Prime Minster Abe's recent comfortable election victory.

So where does that leave us? Lots of brain power is trying to work out exactly when we might reach the inflection point at which the aggregate size of the balance sheet of the world's central banks begins to shrink (with the Fed, ECB and BoJ being the ones that matter for now). The theory is that if a rising tide of liquidity has raised all the boats, then its ebbing will see them fall again, all other things being (which they rarely are!). As long as the US economy continues to grow at a reasonable pace, it is fair to expect policy to keep tightening there, and the pace of QT will accelerate. But we remain confident that the Fed will continue to err on the side of caution if any signs of stress emerge, even if current chair Janet Yellen is replaced. But the ECB has given us a green light for another ten months, at least, while the BoJ has a perpetual programme. So that inflection point seems to have shifted further into 2019. All that suggests no need for greater caution at the moment, but we are painfully aware that the moment is coming, possibly within our eighteen month risk allocation horizon. This is a theme that we will be revisiting regularly over the next year.

Finally, Perry White is the editor of The Daily Planet. This week, who wrote the poem Halloween, published in 1786?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

GKN	5.7%
Micro Focus International	4.7%
Rolls-Royce Holdings	4.7%
Croda International	3.6%
British American Tobacco	3.6%
Reckitt Benckiser Group	3.6%
Rentokil Initial	3.4%

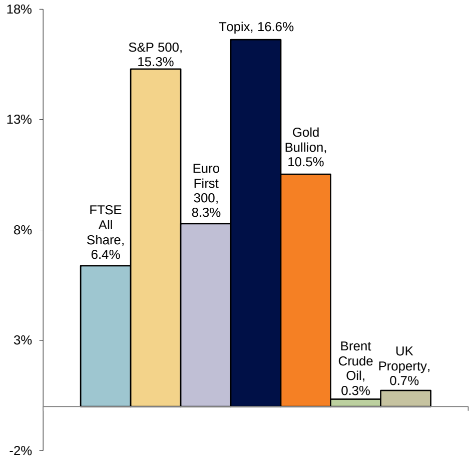
Source: FactSet

FTSE 100 Weekly Losers

GlaxoSmithKline	-10.3%
Mediclinic International	-7.7%
ConvaTec Group	-6.9%
Whitbread	-6.7%
ITV	-6.2%
Barclays	-6.1%
Barratt Developments	-5.5%

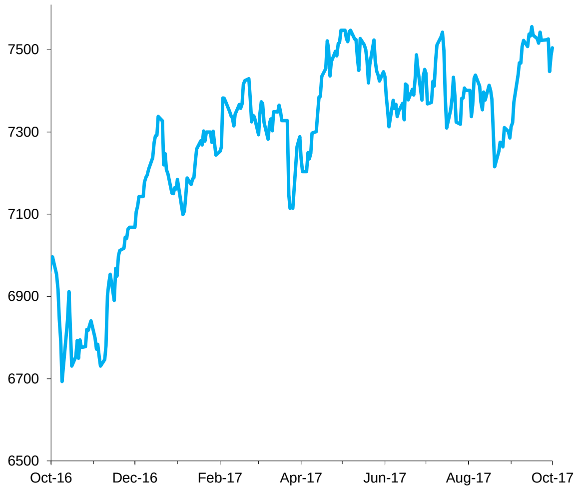
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

IWI740 v1