Weekly Digest

25 September 2017

The weekly insight into world stock markets

Merkel 4.0

Last week I dived into the murky depths of Bitcoin. This week, the headlines are all about someone who has been in power for longer than the cryptocurrency has been in existence, namely Angela Merkel. The 4.0 in the title refers to the fact that she has just been elected as Chancellor of Germany for the fourth time, which is quite a feat in today's turbulent political world. Mind you, she only ranks 36th in Wikipedia's list of current non-royal national leaders – Paul Biya of Cameroon currently leads the table with 42 years in control – although the phrase "voting irregularities" seems to crop up often in the notes of any countries above Germany in the list that vaguely pretend to entertain a democratic process.

At the start of this year we identified three elections that could be viewed as potential hurdles for investors (that was before Mrs May went on her fateful ramble in the hills of Wales), and Germany's always looked like the easiest one to get past. The levels of concern ahead of the Dutch and (especially) French elections ended up providing opportunities to raise weightings in European (ex-UK) equities, but Mrs Merkel was a nailed-on favourite to retain her position. However, the result has been interpreted as a disappointment for her and her party, the Christian Democratic Union. The CDU/Christian Socialist alliance lost 8.5% of its vote from 2013 to poll 33%. That was almost matched by the gains for the far-right Alternative fur Deutschland Party (+8%), which campaigned on an anti-immigration platform. There is little doubt that Mrs Merkel's decision to let in one million-plus refugees was the catalyst behind that swing. Interestingly the liberal Free Democrats (FDP) gained 6%, again mirroring the losses sustained by the Social Democrats, the party that had been in coalition with the CDU. So "fringe" parties gained at the expense of "the establishment", reflecting the populist trends seen elsewhere. So now what?

The expectation is that a new coalition will form, embracing the CDU/CSU, FDP and Greens. Together they polled 53% of the votes. Pulling together a three-way coalition is obviously going to present more challenges, not least the divvying up of cabinet positions. Furthermore, the FDP, while being pro-business, is decidedly less in favour of greater European integration, while the Greens hold more opposing views on both subjects. My suspicion is that the commentariat is trying to make more of this than is justified. Mrs Merkel has already pulled back on the immigration front, even if not apologising for her original decision. The key thing is that the German economy is humming along nicely, so maybe a government that can't actually get in its way could be a deemed a positive thing. The Netherlands seems to be getting on perfectly well without one! It will also depend on how Mrs Merkel reacts to the messages implicit in the result, but if anyone is capable of smoothing potentially ruffled feathers, it is her. Europe (ex-UK) remains our favoured region for equity returns, and markets are barely changed today.

Quite a lot of other things have happened in the last few days which might also have been expected to unsettle markets. These include the spat at the United Nations between Donald Trump and North Korea's Foreign Minister, Moody's decision to downgrade the UK's sovereign debt rating, and the Federal Reserve's confirmation of its plan to start shrinking its balance sheet. But these also failed to shift investor sentiment. Is that a sign of complacency? First, as I have commented on a few times recently, markets continue to take the view that the US/North Korea situation is very much a case of posturing on both sides, and neither leader has any incentive to start shooting first. The latest theory I have heard suggests that Kim Jong-un is stoking up the tension deliberately to keep America in the region so that North Korea doesn't fall under the complete control of China with the possibility of Korean reunification to follow. Talk about counter-intuitive!

On the UK's debt rating, it is ironic that this came immediately in the wake of Theresa May's Brexit speech in Florence that was supposed to clarify the government's position, and also a day after the Chancellor received some welcome news on the public finances, where the deficit was smaller than expected. It is a while since investors have traded government bonds on the basis of credit ratings, other variables being more important. For example, the lowest yielding major government bond market is Japan, which has a relatively lowly rating for a sovereign of A1, but where aggressive Quantitative Easing has led to very low and even negative yields. The US is seen as providing the risk-free rate for the world despite one of its credit ratings being AA+ (rather than the top-notch AAA) and coming close to technical default on a few occasions. The gilt market will carry on regardless, although any long-term deterioration in finances could lead to higher yields eventually (if we assume that QE is unwound).

Last of all, the reversal of the Fed's QE was exceptionally well telegraphed, so fears of another "taper tantrum" were misplaced. The Fed has also set out a clear path from here, and the market appreciates such clarity. Also, the Fed is tightening from a position of strength in the economy, so any potential rise in the discount rate leading to a lower valuation for risk assets is balanced by the growth in earnings and dividends. For now, the equilibrium persists. Finally, Rembrandt's painting Militia Company of District II under the Command of Captain Frans Banninck Cocq is better known as The Night Watch. This week, what is a dobro?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Johnson Matthey	23.2%
Babcock International Group	6.1%
BAE Systems	6.0%
Ferguson	5.7%
Standard Life Aberdeen	5.6%
ITV	5.1%
Royal Dutch Shell Class A	4.2%

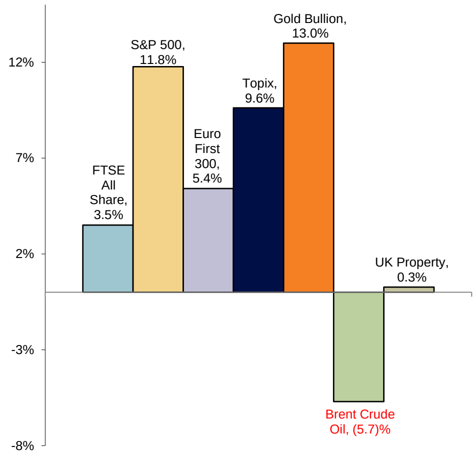
Source: FactSet

FTSE 100 Weekly Losers

NMC Health	-4.0%
Mediclinic International	-3.7%
Imperial Brands	-3.0%
Smiths Group	-3.0%
United Utilities Group	-2.9%
British American Tobacco	-2.7%
Shire	-2.4%

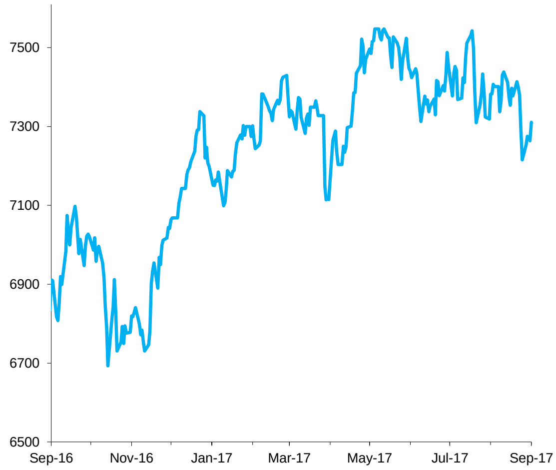
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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