Weekly Digest

3 July 2017

The weekly insight into world stock markets

Investec
Wealth & Investment

Partying With One Eye On The Door

Even as I hit the "send" button on last week's Weekly Digest I feared that I might be tempting fate by suggesting that equity markets could continue to grind higher in the absence of bad news, high valuations notwithstanding. I also highlighted that a surprise tightening of policy by the European Central Bank (ECB) could be a problem. Cue some comments from ECB President Mario Draghi that were interpreted as hawkish. These sent bond markets into a brief tailspin, with equities following them lower. Despite markets remaining near all-time highs, everyone seems to be living on their nerves at the moment. As one of my colleagues expressed it last week: "I am trying to enjoy the party, but I've definitely got one eye on the fastest route to the door".

So what exactly introduced the fly to the ointment? It all seems to have started at an ECB forum in Portugal, where Mr Draghi made comments to the effect that ECB policy is working, Europe's economy is recovering and the threat of deflation is lifting. This was seen by traders as a reason to begin withdrawing extreme monetary stimulus in the form of negative deposit rates and Quantitative Easing (the ECB is currently buying €60 billion of government and corporate bonds every month). The yield on the German 10-year Bund shot up from 0.24% to 0.46%, and the euro gained a cent against the dollar. European equity indices fell 2.5%, and the ripples spread out across global markets. Headline writers had a field day questioning the survival of the bull market.

We have maintained the view that the last thing central bankers want to do is shock markets with unexpected policy changes. Therefore it was not entirely surprising that within twenty-four hours the ECB's press office was leaking comments that markets had not considered the caveats in the details of Draghi's speech and that there was no current intention to tighten policy; he was just laying the ground for future discussions about the possibility of tightening policy.

As is often the case, there is no smoke without fire. There is no doubt that Europe's economy has improved. Indeed it has been the key component of upgrades to global growth forecasts this year. The downward pressure on inflation from lower energy prices has been alleviated, and unemployment across the Eurozone continues to fall, even if there are still large disparities between countries in terms of the current level. Even so, Investec Bank's official forecast for European growth is still only 2.1% this year (and 2% in 2018), so hardly hitting the ball out of the park. We continue to believe that the ECB will play it safe, with a bias towards maintaining growth.

The situation is exacerbated by the fact that there are mixed policy messages coming out of the Bank of England – the last two weeks have something of a hokey-cokey developing in terms of Monetary Policy Committee members contradicting each other – and the Federal Reserve continues to plot a path for interest rates that is steeper than predicted by the futures market. It's fairly clear that major central bankers (with the possible exception of Japan's) are minded to return to more normal monetary policy settings, if only to accumulate some ammunition to deploy during the next downturn, but it's far from clear what "normal" means today. Certainly lower than in previous cycles, we believe, which will bring little solace to those seeking safe income.

And there's the rub. Investors seeking any sort of return remain compelled to invest in riskier assets with the attendant higher volatility. It is absolutely clear that zero/negative interest rates and Quantitative Easing have been hugely supportive for financial assets but to what extent exactly is impossible to calculate. Attempts have been made, including the crudest, which is to overlay a chart of global stock market performance with the size of central bank balance sheets. This particular method suggests that equity markets are running into a headwind as purchases have peaked and the Federal Reserve has laid out plans for gently reducing the assets on its balance sheet, but it's impossible to quantify the risk with great precision.

I have mentioned before that equity markets are potentially running into a battle between stronger growth and higher interest rates. There hasn't been much overall economic expansion in the last few years, but equity markets, led by growth sectors, have continued to prosper as the net present value of future cashflow has been boosted by a lower discount rate. Corporate bonds and real estate have enjoyed similar support. To put it another way, financial assets have re-rated, but there's only so much gas in that tank. The good news is that company earnings have finally started to accelerate. Helped by a strong recovery in the Energy sector, global earnings per share are forecast to rise 14.4% in 2017 and 10.6% in 2018 (Citigroup and Factset consensus data). The bad news is that if bond yields continue to rise they will put downward pressure on valuations. So, very simply, earnings might be running up a down escalator, which means they have to keep sprinting. The positive way of looking at this is to embrace higher bond yields as proof that we continue to distance ourselves from the financial crisis, and the banking sector, especially, returns to health.

For now our risk appetite remains neutral as we see all these factors as finely balanced. Furthermore, as I have previously observed, seasonal factors suggest that markets tend to be more vulnerable to bad news during the summer, so we are happy to watch and wait for now. Finally, the headline act at the first Glastonbury Festival (then called the Pilton Pop, Blues and Folk Festival) in 1970 was Tyrannosaurus Rex. This week, if Irish equals four and Scots equals three, what equals two?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Rio Tinto	6.2%
Anglo American	5.3%
Standard Chartered	5.2%
HSBC Holdings	4.6%
Antofagasta	3.6%
BT Group	3.1%
Sky	2.9%

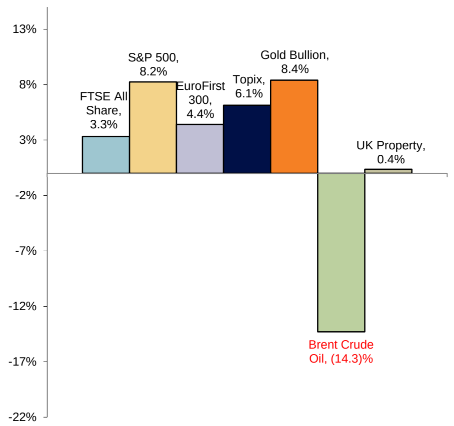
Source: FactSet

FTSE 100 Weekly Losers

Micro Focus International	-7.7%
Fresnillo	-7.4%
Compass Group	-6.6%
Shire	-6.2%
GKN	-5.8%
Paddy Power Betfair	-5.6%
Severn Trent	-5.5%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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