QUARTERLY MARKET COMMENTARY

As another year draws to a close we take a look back over the main political and economic events of 2017 and what 2018 might bring.

2017 has certainly seen its fair share of elections. In the UK, the Conservatives managed to build an alliance with the DUP under a ‘confidence and supply’ agreement, whilst elections in France, Germany, Austria and Holland did not provide any meaningful surprises. Angela Merkel managed to obtain another four-year term as German Chancellor in September but her party, the Christian Democratic Union, together with their previous coalition partners, the Christian Social Union and Social Democrats (SPD) all recorded some of their worst results. Following the results, the SPD announced it would not participate in a renewed grand coalition. Many believed that the poor showing by the largest of political parties in Germany was another sign of the discontent from voters of the ‘open-border’ approach applied by Angela Merkel and her somewhat relaxed tone to the UK over BREXIT negotiations.

Italy is due to hold general elections by no later than 20 May 2018. In the summer, many believed that this could provide the single, largest threat to the EU retaining full membership as the main coalition right-wing parties saw their popularity rise on the back of immigration concerns. However, recent regional elections, which will determine those vying for the national elections, has seen more pro-european parties take a lead, including former Italian leader Silvio Berlusconi’s rightist bloc. Accordingly, the political threat to the EU appears to have abated - at least for now!

In Japan, Shinzo Abe called a quick general election to seize and build upon his significant popularity in the country, following the success to date of his political and economic reforms. Shinzo Abe now ranks as one of the most popular leaders of Japan in recent times.

In contrast, Donald Trump continues with his unique, media focused approach during his term as 45th US President, which has seen him labelled as one of the least popular Commanders in Chief. Many would not contest the fact that in his first year as US President, there has been little meaningful progress made on his election pledges. At the same time, the continued threat of impeachment over his Russian ties and his recent Twitter ‘spat’ with Teresa May on sharing ‘anti-muslim’ videos has done nothing to improve his own political standing or foreign relationships.

Indeed, when our successors study global history, 2017 may well be classed as one of those years when they say ‘that was a significant turning point’. This year was the very first occasion a Chinese president, Xi Jinping, made an appearance at the World Economic Forum in Davos, espousing the benefits of globalisation, the need for free trade and climate control. The Americans were notably absent, allowing China to steal the show – a communist country, the most populous nation on earth and a one-party state. All this is relevant today because the five-yearly National Congress of the Communist party of China concluded in October. President Xi laid out China’s strategic development plan for the next 20 years; a combination of domestic reform, economic stimulus and a comprehensive plan to extend its global influence way beyond its borders.

No Western democracy can emulate China’s capacity and ambition. Indeed, arguably, the West is in disarray. It seems that the US is becoming more introverted and has no coherent foreign policy. Europe seems preoccupied, on the one hand with trying to hold itself together and on the other with trying to integrate further, that it appears to have little time for anything else. China seems to be methodically exploiting the fault lines.

Turning to the investment landscape it is perhaps no wonder then that the commodity markets have been rather resilient over the last year, given China’s infrastructure commitments.

Oil and copper prices, with their industrial use, have increased in value, in US$ terms, by 13% and 10% respectively, whilst the Hang Seng and MSCI Emerging Market stockmarket indices have increased by 26% and 28% year to date, although this has to some extent been helped by US$ weakness. This is in comparison to Western stockmarkets that have increased in value by between 10% and 20% year to date.

The International Monetary Fund (IMF) has recently stated that the global recovery is underway but their forecasts show falling GDP (economic) growth in developed markets from 2% in 2017 to 1.9% in 2018, whilst global emerging market GDP growth is expected to rise from 4.6% to 4.8% in 2018.

The US stockmarket, as measured by the S&P 500 Index, has increased by approximately 20% year to date, although this has largely been driven by the FAANG stocks – Facebook, Amazon, Apple Netflix and Google. Technology stocks have accounted for significant gains over the last year with the US NASDAQ index increasing by 30% since January on the back of earnings revisions, cheap valuations and the proposed cut to corporation tax by Donald Trump.

As at 1 December 2017, the US Senate passed the Tax Cuts & Jobs Act, which should allow the corporate tax rate to be reduced from 35% to 20% in 2019, although the House of Representatives propose to introduce the tax cut in 2018. However, the reforms appear to include a clause that makes it harder for companies to recoup debt interest costs by offsetting them against their corporate tax liabilities. This is anticipated to affect nearly half of the junk bond, fixed interest market and could be the reason why 2 junk bond issuers, NRG energy and Bowie Resources in the US, scrapped plans to issue more debt recently. After circa 14% p.a. returns since 2009, the junk bond sector has seen a 3% fall in the last few months, perhaps highlighting that Donald Trump's fiscal policies of tax cuts and infrastructure spending may not curb inflation or interest rates in the way that monetary policy did over the last 10 years.

Donald Trump's tax cut package represents a big loosening of fiscal policy. It may not be loosening in the areas that many people want it to but it all adds up to a bigger US deficit. A looser fiscal policy, combined with a new central bank boss who is in no real rush to normalise US interest rates, adds up to a much more inflationary set of policies overall. Inflation looks relatively calm and has been for very long time. So one could not be blamed for feeling, particularly after central banks have spent so much time courting it, that inflation is dead.

However, there is a growing view that there is a very close parallel to today's environment. In the latter half of the 1960s, the US had extremely low unemployment – in 1966 the rate was 3.8%. It also had very low inflation. Indeed, at the start of the decade, the US was flirting with deflation and by 1965, annual price inflation stood at just 1.6%. At the time, the Federal Reserve was in no hurry to normalise rates and only did so in 1964 and late 1965. Meanwhile government spending was rising because of the Vietnam war and a campaign to end poverty by Lyndon Johnson. The result was that both fiscal and monetary policy were extremely loose at a time of low unemployment and inflation. Something had to give and that was inflation. By 1970, inflation was rising at just under 6% a year. This precipitated a decade long bear market for fixed interest investors that lost more than a third of their money in real terms!

As we have stated time and again, we cannot predict the future and, therefore, it is more important than ever for medium to long term investors to maintain a diversified portfolio in order to benefit from market rises when they happen and to dilute volatility in the event stockmarkets fall. It is impossible to predict when markets will fall and rise but, in general terms, a sensible investment strategy involves riding out market volatility.

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